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No. 96-843

Supreme Court, U.S.
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# In the Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

*Petitioner,*

v.

JAMES HERMAN O'HAGAN,

*Respondent.*

On Writ Of Certiorari To The
United States Court Of Appeals
For The Eighth Circuit

## BRIEF FOR RESPONDENT JAMES HERMAN O'HAGAN

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## QUESTIONS PRESENTED

1. Whether the misappropriation theory -- which allows a finding of criminal liability for trading in securities on material, nonpublic information in breach of fiduciary duties owed to the source of the information, in the absence of any evidence of a misrepresentation or nondisclosure to, and which induces action or inaction on the part of, a purchaser or seller of the securities or any other participant in the securities transaction -- is encompassed within the text of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b).

2. Whether the Securities and Exchange Commission exceeded its rulemaking authority under §14(e) of the Securities Exchange Act of 1934, 15 USC 78n(e), in promulgating Rule 14e-3(a), 17 C.F.R. §240.14e-3(a), without requiring a breach of fiduciary duty and by extending §14(e) to prohibit trading in advance of a tender offer if "substantial steps" have been taken toward the tender offer.

3. Whether, *in this particular case*, the indictment was structured in such a way as to premise the mail fraud counts on the acts allegedly constituting the securities fraud such that a reversal of the securities fraud counts necessarily compels reversal of the mail fraud counts.

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## STATEMENT

The government appeals the reversal by the Eighth Circuit Court of Appeals of a judgment of conviction entered against respondent on a 57 count indictment, each count of which was based on a single predicate act -- the purchase by respondent of Pillsbury stock and call options during a period of time in which Pillsbury was widely and publicly reported to be a takeover target. Due to the fact-intensive nature of the "theories" advanced by the government in this *criminal* appeal, respondent is compelled to clarify the record.

Respondent is a former attorney whose investment in Pillsbury securities appreciated in value when Grand Met acquired Pillsbury. The government's theory of the case is that -- despite the fact that respondent began investing in Pillsbury in July 1988, based on solicitations from his brokers -- respondent's investments dated after August 26, 1988, were completed while respondent was in possession of material, nonpublic information that he learned while a partner at Dorsey & Whitney, a large Minneapolis law firm ("Dorsey"). The government alleges that by purchasing Pillsbury stock and call options, respondent breached a fiduciary duty to the Dorsey firm and to Dorsey's client, Grand Met, and thereby violated the securities laws.

The government offered no evidence to support its claim that respondent traded in Pillsbury securities on the basis of material, nonpublic information obtained from his law firm other than a single conversation which allegedly took place between Dorsey partner Thomas Tinkham and respondent on, or slightly before, August 26, 1988, concerning the Dorsey firm's representation of an undisclosed client of the law firm of Cravath, Swaine & Moore ("Cravath")[1] in connection with a possible acquisition of the

[1] Because the Dorsey firm opened its file on the matter as "Cravath, Re: General," without reference to the name of either Grand Met or Pillsbury, the firm's bookkeeping department was not notified that the firm's representation involved Pillsbury. Dorsey's managing partner testified that, consistent with the firm's policy regarding securities trading, *any* member of the firm was free to trade in Pillsbury securities in July through September 1988. (JA 32-33, 122).

Pillsbury Company.[2] The government alleges that, in that August 26 conversation, respondent *confirmed* what he had previously learned: that Dorsey was representing an undisclosed client in connection with a possible acquisition of Pillsbury. (Govt. Br. at 4 n.1). The government concedes, however, that it cannot prove when or from whom or by what means respondent first obtained the "material, nonpublic information" on which he is alleged to have traded.[3]

The facts leading up to the alleged conversation with Tinkham are, for the most part, undisputed. Respondent began investing in Pillsbury on July 27, 1988, when a broker, based on takeover rumors, solicited respondent for a 5,000-share purchase of Pillsbury stock for a total of approximately $180,000.[4] (JA 174-75). On August 18, 1988, another broker, James Consideine, advised respondent that he had received a $9 million order to purchase 250,000 shares of Pillsbury at the market from a London, England account. (JA 164-67). Based on this information, publicly circulated rumors, and the solicitations of other brokers, respondent decided to take the exact same position in Pillsbury as Consideine's customer. (JA 37-51). Since respondent did not have or want to risk $9 million, however, he decided to buy 2500 call options with limit orders and thereby control 250,000 shares.[5]

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[2] Respondent contends that the conversation with Tinkham occurred on September 21, 1988, rather than on August 26, 1988, but the difference is not central to this appeal because Respondent placed all of his options orders before August 26, 1988.

[3] In this regard, prosecutor Bebel admitted at the close of the government's case that: "There's no *specific evidence* as to the manner in which he *first obtained* the evidence, as to whether it was by conversation or by documentation." (JA 168 (emphasis added)).

[4] Respondent was very active in the stock market and, on August 1, 1988, weeks before the alleged conversation with Tinkham, held positions in listed securities with a value of approximately $5 million. (Trial Transcript ("Tr.") Vol. II, p. 39).

[5] The government's expert, Judy Kallaus, testified that this is a common investment strategy. (Tr. Vol. V, p. 205).



With the exception of one order for 5,000 shares of Pillsbury stock that was confirmed on September 20, 1988, (JA 154), respondent's orders for Pillsbury stock or call options were placed *prior* to August 26, 1988 -- the date on which the government alleges respondent acquired the material, nonpublic information which gives rise to its claims of securities fraud.[6] Respondent's

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[6] The government asserts that after his discussion with Tinkham, respondent accumulated additional Pillsbury call options. (Govt. Br. at 5). This statement is misleading in its implication that respondent acted to acquire Pillsbury options on the basis of information provided him by Tinkham. In fact, the orders for the Pillsbury options had been placed by respondent *prior* to the alleged August 26, 1988 discussion with Tinkham. (*See* JA 214). Although respondent's orders, which were below-the-market limit orders, were not executed by his broker until late August or early September, he began ordering significant blocks of options on August 18 and had placed most of his orders for both options and stock on or before August 25. (*See* JA 39-54, 173-77). As the government admitted below, even under its theory of the case trades prior to August 26, 1988, could not be illegal because respondent had no inside information prior to that date. (JA 58-59). Because the essential inquiry in this case is whether respondent traded in securities *on the basis of* material, nonpublic information, moreover, the relevant operative act is the date on which respondent placed his orders for securities, *not* the date on which the orders were filled by respondent's brokers. The government failed to appreciate this distinction before the district court, asserting in a brief submitted to the court that "neither the defendant's decision to violate the law through the placement of orders for Pillsbury securities, nor his act of placing orders for those securities, amounts to a transgression of Section 10(b). Rather, *the actual purchases of securities* on O'Hagan's behalf ... serves as the conduct which amounts to a violation of Section 10(b) and Section 14(e)." (Govt. Resp. to Defendant's Mtn. Dismiss, April 9, 1993, at 33-34 (emphasis added)).

In its brief to the court of appeals, the government essentially conceded the Achilles heel of its argument -- that respondent traded *on the basis of* misappropriated material information -- when it admitted that respondent placed the orders for the Pillsbury securities in question *prior* to the conversation with Tinkham: "Although Tinkham had no way of knowing, O'Hagan *had set* himself on a course of accumulating an exceptional number of Pillsbury securities." (Govt. Ct. of App. Br. 9 (emphasis added)).

In its Petition for Certiorari, the government suggested that it is significant that, after his discussion with Tinkham, respondent shifted from purchasing Pillsbury call options with September expiration dates to purchasing options

purchase of Pillsbury securities had no impact on the price of Pillsbury shares, as the government concedes. (*See* Govt. Br. at 3).

At the time of the Tinkham/O'Hagan conversation, Grand Met's designs on Pillsbury were no secret. On August 18, 1988, the well-known financial columnist Dan Dorfman ("Dorfman") announced on Cable News Network ("CNN") that "people close to Grand Metropolitan ... are telling people in the street that Grand Metropolitan is interested in acquiring Pillsbury." (JA 78-80).[7] On August 12, 1988, the Wall Street Journal reported that Grand Met had put its hotel chain up for auction to raise money for an acquisition and, on August 22, 1988, Investment Dealers Digest announced that Grand Met was selling its hotel chain in order to buy Pillsbury. (Govt. Ex. 57; JA 73-74 ).

It was against this backdrop that the discussion between Tinkham and respondent took place. Tinkham testified that the discussion, lasting no more than five minutes, occurred as he was preparing to meet with partners from the law firm's corporate department to discuss whether the firm should represent Grand Met in its efforts to take over a local company. According to Tinkham, as he was preparing for the meeting, respondent stopped by his office. Respondent told Tinkham that he understood that Tinkham was working on a takeover of the Pillsbury Company and suggested he would be interested in working on the matter, noting that he "hated the Pillsbury Company" based on prior business dealings.[8] (JA 129; *see generally* Appendix to Respondent's Opposition to Certiorari (Tinkham transcript)). Tinkham declined respondent's offer to work on the case. Tinkham mentioned,

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with later expiration dates. (Govt. Pet. at 5). But the only pertinent evidence on this point confirms that the options with later expiration dates were purchased to fill orders placed prior to August 26, and that the change in the expiration dates occurred at the suggestion of respondent's broker. (*See* JA 176-77).

[7] The government's expert, Michael Kennedy, testified that Dorfman's information probably came from Grand Met insiders (JA 79-80).

[8] Although the government now asserts that respondent "feigned an interest in working on litigation involving the Pillsbury takeover," (Govt. Br. at 20), nothing in the record supports this characterization.



however, that he was going to meet with the partners from the corporate group. Tinkham testified that this led to a short discussion "about a general policy relating to [the firm's] non-involvement in hostile takeovers of local companies." (JA 132).

During trial, the government asserted repeatedly that respondent learned from his law firm of *Grand Met's* plans to acquire Pillsbury. (*See, e.g.*, JA 189). Indeed, in its Petition for Certiorari to this Court, the government asserted that "[a]lthough Tinkham declined respondent's offer to work on the case, *Tinkham discussed Grand Met's plans to acquire Pillsbury's common stock with respondent.*" (Govt. Pet. at 4 (emphasis added)). This assertion misstates the undisputed record as to what respondent actually learned from Tinkham. Construing the evidence in the light most favorable to the government, the most that can be said is that respondent's conversation *confirmed* something the government asserts respondent already knew: that Dorsey had been retained to represent an *undisclosed* client in connection with a *possible* takeover of Pillsbury.[9] As the district court found, respondent did *not* learn that the Dorsey client was Grand Met. (*See* JA 132).[10] Moreover, respondent did not learn - and could

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[9] The government has never contended, and did not contend at trial, that the fact that Dorsey had been retained in connection with a possible takeover of Pillsbury was itself material information sufficient to sustain a securities fraud claim. Instead, the government has always emphasized that respondent had knowledge of something more; specifically, Grand Met's "secret plan." Nothing in the record of this case would support a finding that Dorsey's retention was material information and, indeed, the trial court prevented respondent from offering expert testimony that there was nothing material about the information that the Dorsey firm had been retained by someone in connection with a possible takeover of Pillsbury. (Tr. Vol. XI, pp. 29-30).

[10] In denying respondent's motion to dismiss the indictment, the district court found that "an essential element of the offenses" with which respondent was charged was the government's allegation in paragraph 14 of the indictment that respondent "learned his firm was retained *by Grand Met* to represent them in connection with a tender offer *and then* purchased Pillsbury stock and call options..." (Magistrate's Report (September 10, 1993) at 14-15 (emphasis added)). There is no evidence to support this "essential element" of the government's case. After the government rested, the district court

not have learned -- any details of any takeover plan. At the time of the Tinkham/O'Hagan conversation, the details of Grand Met's takeover plan had not been formulated.

The undisputed evidence shows that, although as of September 18, 1988, Grand Met had made a decision "in principle that [it] would like to acquire Pillsbury," even at that time, "*the decision to launch the hostile tender offer had not been taken.*" (JA 182-83 (emphasis added)). As explained by Paul S. Walsh, the then Chief Financial Officer of Grand Met and currently the Chief Executive Officer of Pillsbury, Grand Met could not pursue Pillsbury unless and until it sold its hotel subsidiary, Intercontinental Hotels ("ICH"), to fund the offer -- a transaction that was by no means a foregone conclusion at the time of the O'Hagan/Tinkham conversation. (JA 180-81).[11] The Grand Met board required a signed contract for the sale of the hotel subsidiary before any tender offer for Pillsbury could be considered. According to Walsh, "Had we not found a purchaser of our hotel division, we would have delayed the acquisition of Pillsbury until we found such a purchaser." (JA 181). Grand Met sold ICH on September 30, 1988, and Mr. Walsh himself did not "first learn that a tender offer indeed would be made for Pillsbury" until October 1, 1988. (JA 182). Thereafter, the Grand Met board met on October 3, 1988, and authorized a hostile tender offer for Pillsbury.

Thus, the record is unequivocal that on August 26, 1988, Grand Met had not made a decision to launch a hostile takeover of Pillsbury and, indeed, lacked the financial resources to commence the tender offer. The Dorsey firm withdrew from its representation

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acknowledged that the government had failed to prove this part of its case when the court stated: "[T]*he record says he didn't know it was Grand Met's information.*" (JA 167 (emphasis added)).

[11] An August 12, 1988 article in the Wall Street Journal reporting that Grand Met had put its hotel subsidiary up for auction to raise money for an acquisition noted that Grant Met was asking $2.5 billion for a company Grand Met had purchased for $600 million in 1986. Several experts were quoted in the article to the effect that the price was "outrageous" and would never be obtained. (Govt. Ex. 57).



of Grand Met on September 9, 1988, and did not represent Grand Met in the tender offer.[12]

Both before the district court and on appeal, respondent argued that the government had failed to produce evidence essential to support the charges included in the indictment, including specifically any evidence that respondent had purchased securities on the basis of "material, nonpublic" information. Respondent also challenged the legal theories under which he was indicted, including those at issue before this Court.

On August 2, 1996, the court of appeals reversed respondent's convictions on all 57 counts of the indictment. *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996). The government's subsequent petition for rehearing and suggestion for rehearing en banc was denied on November 13, 1996, with only one judge voting to grant an en banc hearing.

## The Opinion of the Court of Appeals

While not rejecting any of the eight grounds for reversal asserted by respondent, the court of appeals reversed respondent's conviction on all counts on the basis of three arguments. First, the court found that neither the statutory language of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j(b), nor Supreme Court precedent interpreting it, will support the use of the misappropriation theory, the theory which formed the basis for O'Hagan's §10(b) securities fraud convictions. Second, the court held that the Securities and Exchange Commission

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[12] The decision to withdraw was made by the Dorsey firm on September 9, 1988. (JA 108). Tinkham advised Cravath on September 11, 1988 of Dorsey's withdrawal. In his conversation with Cravath partner Charles Parker, Tinkham indicated that he had not realized until September 9 that the representation "would involve hostile litigation." (JA 108-09). Thus, the evidence establishes only that, as of August 26, 1988, Tinkham knew that Grand Met was interested in acquiring all of Pillsbury's stock at some unknown time in the future. (*See* JA 124-25 (Tinkham testimony), *see also* JA 180-83 (testimony of Pillsbury CEO Paul Walsh)). There is no evidence that Tinkham divulged even this fragmentary knowledge to respondent.

exceeded its rulemaking authority under §14(e) of the Exchange Act, 15 U.S.C. §78n(e), when it promulgated Rule 14e-3(a), 17 C.F.R. §240.14e-3(a), and omitted therefrom the requirement that a breach of a fiduciary duty be shown in order to violate the rule. Finally, because the mail fraud counts were structured in the O'Hagan indictment so as to hinge on the validity of the securities fraud counts, the court vacated these counts as well. Judge Fagg wrote a single paragraph in dissent in which he acknowledged that the majority's opinion was "carefully analyzed" and "well reasoned," but disagreed with its result. 92 F.3d at 628.

## SUMMARY OF ARGUMENT

This is a criminal case controlled by two fundamental principles of law. First, an administrative agency's interpretation of a statute under which it has been given rule-making authority is limited by the language of the statute itself; an administrative rule that exceeds its statutory mandate is invalid. *See Central Bank, N.A. v. First Interstate Bank, N.A.* 511 U.S. 164 (1994). Second, those accused of criminal conduct are entitled to meaningful notice of the law. *Hynes v. Oradell*, 425 U.S. 610 (1976); *Buckley v. Valeo*, 424 U.S. 1 (1976). Penal statutes must be written in language that to the "common world" is clear and definite so as to insure that no individual is convicted unless a fair warning has first been given of what the law intends to do if a certain line is passed. *Babbitt v. Sweet Home Chapter of Communities for a Great Or.*, __U.S.__, 115 S.Ct. 2407 (1995); *Mourning v. Family Publications Serv., Inc.*, 411 U.S. 356 (1973). Respondent's conviction in this case contravened both of these settled principles of law and, accordingly, the Eighth Circuit Court of Appeals acted properly in reversing the conviction.

### A. Misappropriation Theory

In the context of this case, the touchstone of liability under §10(b) is a finding of deception "in connection with the purchase or sale of a security." The misappropriation theory, under which



respondent was convicted, does not require "deception," but instead "permits the imposition of §10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure." *O'Hagan*, 92 F.3d at 618. This result contravenes the holdings of *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), and *Central Bank*, which established that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of §10(b).

In addition, although the language of §10(b) requires that the fraud alleged be "in connection with the purchase or sale of any security," the misappropriation theory renders this requirement nugatory, permitting liability for a breach of duty owed to individuals who are unconnected with a securities transaction. This result is inconsistent with *Chiarella v. United States*, 445 U.S. 222 (1980), *Dirks v. SEC*, 463 U.S. 646 (1983), and *Central Bank*, which limit liability under §10(b) to situations involving a breach of duty to participants in a securities transaction.

Contrary to the government's argument, whether the misappropriation theory is necessary to combat securities fraud, and should therefore be enacted as law, is a determination for Congress, not the courts, to make. In the words of this Court, "[t]he issue [here presented] is not whether imposing ... liability ... is good policy but whether [it] is covered by the statute." *Central Bank*, 114 S.Ct. at 1448; *see Dunn v. Commodity Futures Trading Comm'n*, __U.S.__, 117 S.Ct. 913, [illegible] (1997) (argument that "options are particularly susceptible to fraud and abuse if not carefully policed" was one "best addressed to the Congress, not the courts"). Similarly irrelevant is the argument of the government and certain amici that statements in the legislative history of the 1984 and 1988 amendments to the securities laws, none of which dealt specifically with the statutory provisions here at issue, indicate Congressional approval of the misappropriation theory. "Congress may legislate ... only through passage of a bill which is approved by both Houses and signed by the President." *Central Bank*, 114 S.Ct. at 1453. Congress has not amended §10(b) to codify the misappropriation theory. Isolated statements by

members of a subsequent Congress as to the meaning of a statute enacted by an earlier Congress are, at best, legislative dicta, *Dunn*, 117 S.Ct. at 919-20, and, therefore, are not determinative of any issue in this case.

At the time of the alleged conduct here at issue, no statute creating a cause of action for misappropriation had been enacted. Even if this Court were to conclude that an argument for implying such a cause of action in §10(b) could be made, there is sufficient uncertainty concerning both the statutory authorization for the theory and its parameters to avoid, for purposes of due process, its application in a criminal context. *See Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972).

**B. Rule 14e-3(a)**

The SEC exceeded its rulemaking authority in promulgating Rule 14e-3(a) without including a requirement of a breach of fiduciary duty. Rule 14e-3's enabling statute, §14(e) of the Exchange Act, makes it unlawful for any person to engage in any "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." This Court has held that a failure to disclose material nonpublic information is "fraudulent" (the relevant term at issue), only when "one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." *Chiarella*, 445 U.S. at 228 (quoting *Restatement (Second) of Torts* §551(2)(a)). Accordingly, the term "fraudulent" under §14(e) requires a breach of fiduciary duty.

Contrary to the government's position, the rulemaking provision of §14(e) does not authorize the SEC to redefine common law fraud. The enabling provision of the statute simply permits the SEC to define "such acts and practices *as are fraudulent*." This Court explicitly rejected the government's argument in *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985), with regard to the term "manipulative," stating that the rulemaking provision authorized the SEC to prevent manipulative acts "without suggesting any change in the meaning of the term 'manipulative'



itself." *Id.* at 11 n.11. Neither the text nor the legislative history of §14(e) provides the "explicit evidence of congressional intent" required for such a dramatic departure of established law, *Chiarella*, 445 U.S. at 233, and any ambiguity should be resolved in favor of lenity.

Rule 14e-3 also improperly extends §14(e) to prohibit trading in advance of a tender offer if "substantial steps" have been commenced toward that offer. The plain language of §14(e) prohibits fraudulent acts "in connection with a tender offer," and the "sole purpose" of the Williams Act was "the protection of investors who are confronted with a tender offer." *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 35 (1977). The SEC's expansion of §14(e) is unreasonable, as it fails to comport with due process on two levels. First, Rule 14e-3 does not define "substantial steps" and thus fails to give fair notice as to when, in advance of an offer, the violation occurs. Second, Rule 14e-3 does not require that the defendant have knowledge of the triggering "substantial steps." An individual may now be imprisoned under §14(e) for trading in advance of a tender offer without any knowledge of any offer. The statute, as well as due process, requires more.

**C. Mail Fraud Counts**

The court of appeals reversed respondent's mail fraud convictions because "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." 92 F.3d at 627.[13] This holding was correct because respondent's indictment specifically uses the statutory language of §10(b) as an element of mail fraud, as it charges that the "scheme to defraud" element of mail fraud is a scheme "in connection with the purchase and sale of securities." The court was careful to point out that it was *not* holding, as a matter of law, that where both mail fraud and

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[13] Judge Fagg, in dissent, did not disagree with the court of appeals' finding. He simply noted that, since he would uphold the securities fraud convictions, he found no basis to reverse the conviction for mail fraud. 92 F.3d at 628.

securities fraud counts are brought, they are necessarily interdependent so that the dismissal of one requires the dismissal of the other. *Id.* ("The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed.") Therefore, the conflict which the government seeks to create between this case and *Carpenter v. United States*, 484 U.S. 19 (1987), is illusory. The decision of the court of appeals, accordingly, should be affirmed.

## ARGUMENT

### I. THE MISAPPROPRIATION THEORY IS AN INVALID EXTENSION OF §10(b)

The government indicted respondent for securities fraud in violation of §10(b) of the Exchange Act and Rule 10b-5 promulgated pursuant thereto. Section 10(b) prohibits the use:

> in connection with the purchase or sale of any security [of] ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe ... in the public interest or for the protection of investors.

In 1942, acting pursuant to the authority granted to it under §10(b), the SEC promulgated Rule 10b-5 which provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, * * *
>
> (a) [t]o employ any device, scheme, or artifice to defraud, [or] * * *
>
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Rule 10b-5 has been described by this Court as a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). By imposing *criminal* liability under Rule 10b-5 via the SEC-invented "misappropriation theory," the government asks this Court to remake a "judicial oak" into a prosecutorial Tyburn tree.



In 1961, almost 30 years after §10(b) was enacted and 19 years after Rule 10b-5 was promulgated, the SEC thought up a theory of liability under Rule 10b-5 that it called "insider trading." *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The theory initially evolved into what has now been characterized as the "classical theory" of insider trading, where a person violates Rule 10b-5 "when he or she at the same time is an insider of the corporation whose securities are traded." *O'Hagan*, 92 F.3d at 616 (quoting *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991)). The government's first attempt to expand its theory of "insider trading" to reach "outsiders" was rejected by this Court in *Chiarella*, *infra*. Not satisfied with *Chiarella's* limitations, however, the government invented the "misappropriation theory" to reach the conduct of "outsiders" who owe no fiduciary duty to the shareholders of the company whose securities are traded, but owe a duty to the outside "source" of the information.

In derogation of the "classical theory," the "misappropriation theory" jettisons the statutory requirement of deception in connection with the purchase or sale of a security in a misplaced attempt to "fill a gap" in the law. (Govt. Cert. Pet. at 12). Because it rests upon no statutory foundation, this "theory" has become increasingly unclear. Now rejected by both the Fourth and the Eighth Circuits, the theory has been the subject of uncertainty and confusion even in those circuits which have adopted it.[14] *See SEC*

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[14] The amicus briefs filed in this case in support of the government only underscore the ambiguity inherent in the misappropriation theory. In its brief amicus curiae, the American Institute of Certified Public Accountants argues the need for a "coherent interpretation of the statutory language that can be applied by the lower courts." (Br. at 2). Another of the amici, the Association for Investment Management and Research, urges the Court to "clarify" the misappropriation theory, arguing that a clearly defined misappropriation theory will give guidance and protection to investment analysts and market participants generally and that "uncertainty concerning the scope of the

*v. Lenfest*, 949 F.Supp. 341, 343-44 (E.D. Pa. 1996) (noting differences in the formulation of the misappropriation theory between the Seventh and Ninth Circuits). The inconsistency in the theory's application within the Second Circuit, from which it originated, led one court to comment that the theory's "harrowing evolution [is] almost a testament to the theory's invalidity." *United States v. Bryan*, 58 F.3d 933, 953 (4th Cir. 1995).

In short, neither the language of §10(b) nor the decisions of this Court interpreting §10(b) and Rule 10b-5 support the misappropriation theory, as applied in this case. Even if this Court were to conclude that the theory can be reconciled with the text of §10(b), moreover, the confusion surrounding the scope of the theory and the uncertainty concerning its statutory authorization preclude the application of the theory, consistent with due process, in a criminal context.

### A. The Misappropriation Theory Is Not Encompassed Within The Text Of §10(b), Nor Can It be Reconciled With This Court's Interpretations Of The Statute.

"'The starting point in every case involving construction of a statute is the language [of the statute] itself.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)); *see also Central Bank*, 114 S.Ct. at 1446 ("It is inconsistent with settled methodology in §10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.").[15] The touchstone of

misappropriation theory" currently chills the free flow of information. (Br. at 11-12).

[15] In *Central Bank*, this Court refused to extend §10(b) to cover aider and abettor liability, despite the fact that "[i]n *hundreds* of judicial and administrative proceeding in every circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under §10(b) and Rule 10b-5." 114 S.Ct. at 1456 (Stevens, J., dissenting). There is no similar consensus among the courts as to either the parameters of the misappropriation theory or its inclusion in §10(b). *See* discussion at 28-29, *infra*.



liability under §10(b) is the existence of "manipulation" or "deception" "in connection with the purchase or sale of any security." *See Santa Fe*, 430 U.S. at 473 ("The language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."). "Manipulation" is "virtually a term of art" in the securities context, referring "generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity," *id.* at 476, and has no relevance to the facts of this case, or an assessment of the misappropriation theory. The validity of the misappropriation theory, as applied in this case, then, turns on the meaning of the statutory phrase "deceptive device" "in connection with the purchase or sale of a security."[16]

#### 1. The misappropriation theory does not require deception within the meaning of §10(b), but instead turns on a showing of a conversion in breach of a fiduciary duty.

As this Court noted in *Chiarella*, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." 445 U.S. at 234-35. More specifically, §10(b) catches a particular kind of fraud -- deception. Deception or deceit has a specific legal meaning. As defined by the *Restatement (Second) of Torts*, deceit involves a fraudulent misrepresentation or a failure to disclose where there is a duty to disclose which induces another person to act to his detriment or to refrain from acting in reliance upon the misrepresentation or omission. *See Restatement* §§525,

[16] In contrast to §10(b), Rule 10b-5 prohibits "fraud" in describing the deception proscribed under §10(b). 17 C.F.R. §240.10b-5. However, "fraud under Rule 10b-5 cannot be construed more broadly than its statutory enabler, deception; in other words, Rule 10b-5 fraud cannot prohibit conduct that does not amount to §10(b) deception." *O'Hagan*, 92 F.3d at 615. *See also Ernst & Ernst*, 425 U.S. at 214 (SEC's authority does not extend beyond the scope of power granted it by Congress under §10(b)).

551.[17] Consistent with this definition of deceit, this Court has consistently defined the type of conduct encompassed within §10(b) to require a misrepresentation or an omission where there is a duty to disclose. Thus, in *Santa Fe*, the Court rejected the Second Circuit's position that "neither misrepresentation nor nondisclosure [is] a necessary element of a Rule 10b-5 action," and held that the "deception" proscribed by §10(b) is the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose. 430 U.S. at 470. More recently, in *Central Bank*, 114 S.Ct. at 1448, the Court reaffirmed that: "As in earlier cases considering conduct prohibited by §10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[18]

The essence of the misappropriation theory -- as used by the government in this case and elsewhere -- is not deception, but a breach of a fiduciary duty by one who misuses or converts nonpublic information entrusted to him by another in confidence for personal gain. As stated by the government, "[u]nder the misappropriation theory of insider trading, a person commits fraud on the source of information for securities trading when he *uses* confidential information for his trading in a *breach of a fiduciary or similar duty owed to the source*." (Govt. Br. at 14 (emphasis added)). It is the "trading on converted confidential information" that, in the government's view, "implicates Section 10(b)'s protections against fraud in connection with securities trading." (*Id.* at 15). As applied by the government in this case and others, "theft rather than fraud or deceit, seems the gravamen of the [misappropriation] prohibition." *United States v. Chestman*, 947

[17] "Deceit" was similarly defined at the time of §10(b)'s enactment. *See Restatement of Torts* §§525, 531 (1938); *Black's Law Dictionary* 336, 522 (2d ed. 1910) (definitions of "deceit" and "fraudulent misrepresentation").

[18] The government's suggestion that a meaningful distinction can be drawn between deception in general and §10(b)'s reference to a "deceptive device" ignores the fact that, whatever a "deceptive device" is, it must necessarily entail deception.



F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part).

In an attempt to fit the misappropriation theory within the confines of §10(b), the government contends that conversion by an agent of confidential information entrusted to him by his principal is a "well recognized species of fraud," citing this Court's decision in *Carpenter*. The government asserts that "[s]ince 'it is impossible for a person to embezzle the [property] of another without committing a fraud upon him,' ... misappropriation may be considered, as it was in *Carpenter*, a 'garden variety' type of fraud." (Govt. Br. at 17 (citations omitted)). Deception, as defined by this Court for purposes of §10(b), however, is not a "garden variety" type of fraud. It is a very specific type of fraud, which is dependent upon a showing of a misrepresentation or nondisclosure in violation of a duty to speak which induces another to act or to refrain from acting to his detriment.[19]

The government urges this Court to collapse the separate torts of misappropriation (or conversion) and deception into one for purposes of §10(b) by holding that the tort of deception is necessarily inherent in any misappropriation of confidential information by one standing in a fiduciary relationship to the owner of the information. In the government's words, "[c]onversion of confidential information by its very nature involves deception." (Govt. Br. at 19). The government transmutes conversion into deception by implying into an agent's dealings with his principal a continuing representation that the agent is honest and loyal to the principal's interests. Under the government's theory, the

[19] *Carpenter* was decided, not under §10(b), but under the mail fraud statute which predicates liability on the establishment of a "scheme to *defraud*" rather than deception. As the court of appeals noted below, this Court has refused to import into §10(b) all concepts of fraud appearing in other federal statutes. *O'Hagan*, 92 F.3d at 621 (citing *Santa Fe*, 430 U.S. at 471-72). While the misappropriation alleged in *Carpenter* and the embezzlement in *Grin v. Shine*, 187 U.S. 181, 189 (1902), cited in *Carpenter*, may constitute examples of "a garden variety" of fraud, conversion and embezzlement are not synonymous with deception because they do not require misrepresentation, nondisclosure, or inducement. *Carpenter*, then, is not dispositive of this case.

nondisclosure of the breach is a deception because the breach necessarily renders untruthful the agent's implicit continuing representation of loyalty.[20]

In *Santa Fe*, however, this Court specifically rejected the view of the Second Circuit that "neither misrepresentation nor nondisclosure [is] a necessary element of a Rule 10b-5 action" and that a breach of fiduciary duty, in and of itself violates §10(b). 430 U.S. at 470. In the Court's words:

> To the extent that the Court of Appeals would rely on the use of the term "fraud" in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

430 U.S. at 472. In *Central Bank*, the Court reiterated that §10(b) does not "reach[] breaches of fiduciary duty ... without any charge of misrepresentation or lack of disclosure." 114 S.Ct. at 1446.[21]

The government argues that because *Santa Fe* involved "a transaction in which all material facts were fully disclosed," it does not "create doubt that misappropriation in breach of a fiduciary or similar duty is 'deceptive.'" (Govt. Br. at 19). Under the theory posited by the government in this case, however, there *was*

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[20] As noted by Professor Coffee, one of the government's amici in this case, in commenting on the "fiduciary breach" theory of mail fraud: "[T]he protean character of the term 'fiduciary' has enabled the prosecutor to reach areas that *Congress never contemplated would be subject to federal criminal sanctions*." John C. Coffee, *The Metastasis of Mail Fraud: The Continuing Story of the "Evolution" of a White-Collar Crime*, 21 Am. Crim. L. Rev. 1, 1-2 (1983) (emphasis added).

[21] In *Dirks*, the Court confirmed that the position stated by the Court in *Santa Fe* and *Central Bank* also applied in criminal and enforcement actions under §10(b): "Not 'all breaches of fiduciary duty in connection with a securities transaction' ... come within the ambit of Rule 10b-5. There must also be 'manipulation or deception.'" 463 U.S. at 654.



deception in *Santa Fe*. The majority shareholders in *Santa Fe* had a fiduciary duty to the minority shareholders which was breached. Consistent with the argument advanced by the government here, that breach necessarily entailed deception because the majority shareholders impliedly misrepresented to the minority shareholders that they were acting honestly and in the best interests of the business. Had the Court in *Santa Fe* agreed with the government's contention that a breach of fiduciary duty necessarily entails deception, it would *not* have found in *Santa Fe* that there had been full disclosure. The breach alone would have established the requisite misrepresentation.

In stating that a breach of fiduciary duty without misrepresentation or nondisclosure does not constitute deception for purposes of §10(b), then, this Court in *Santa Fe* must have rejected the contention that deception can be founded upon the implied misrepresentation which the government posits is inherent in every breach of fiduciary duty, including the breach of fiduciary duty in *Santa Fe*.[22] At the very least, because deception involves inducing another to act to his detriment, a breach of fiduciary duty, in order to constitute deception, would have to be shown to have induced action on the part of another. In *Santa Fe*, the majority shareholders' breach of fiduciary duty to the minority shareholders did not induce the minority shareholders to act to their detriment since they were provided with all material information necessary to their decisionmaking. Similarly, in this case, respondent's alleged

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[22] As Professor Coffee has noted, there are "troubling consequences" inherent in criminalizing fiduciary breaches, including specifically the fact that "significant differences exist among state jurisdictions in terms of the duties that fiduciaries owe, thereby possibly creating significant disparities in the coverage of federal criminal law depending on the applicable civil law." John C. Coffee, *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 Am. Crim. L. Rev. 117, 150 (1981). Absent a clear mandate of Congress authorizing the criminalization of breaches of duties defined by such things as workplace rules and professional codes of responsibility, the courts may not federalize breaches historically left to the states to punish.

breach of fiduciary duty cannot be said to have induced Grand Met or Dorsey to act or refrain from acting to its detriment.

The government has suggested that the misappropriation theory can be reconciled with §10(b)'s requirement of deception because "misappropriation will often involve overt lies," citing as one example, respondent's "feign[ing] an interest in working on litigation involving the Pillsbury takeover." (Govt. Br. at 21). This reference to "feigned interest" is a semantic artifice of appellate counsel used to suggest an aura of "deception" when the record is devoid of any such evidence and this was never argued below. Nor was it ever suggested below that respondent's alleged "feigned interest" induced Tinkham (or Grand Met) into doing, or refraining from doing, anything. Tinkham dismissed out of hand respondent's interest in working on any Pillsbury litigation. (JA 130). According to Tinkham, he disclosed to respondent that Dorsey was representing an unnamed client in connection with a possible acquisition of Pillsbury simply because, as a partner, respondent was entitled to the information. (JA 131). It is, thus, not the fact that respondent was able to *obtain* information about Dorsey's representation of an unnamed entity in connection with a possible acquisition of Pillsbury about which the government complains; rather, it is his *use* of the information -- *i.e.*, the misappropriation or conversion of that information in breach of a fiduciary duty -- which is the gist of the alleged crime.

Assuming arguendo that the facts in this case could support a finding of deception within the meaning of §10(b), however, the government still could not prevail, because the indictment did not charge respondent with deception, and the jury was not instructed that it had to find deception to return a verdict against respondent for securities fraud. The indictment charges that respondent:

> engaged in a scheme and artifice to defraud Grand Met and Dorsey and Whitney in connection with the purchase and sale of securities *by purchasing* Pillsbury common stock and call options on Pillsbury common stock *while in the possession* of material, non-public information concerning Grand Met's future tender offer for Pillsbury common stock.



Indictment, Description of Scheme to Defraud ¶2 (JA 8 (emphasis added)). Nothing in this paragraph, or elsewhere in the indictment, alleges that respondent ever misrepresented anything or failed to disclose to his law firm anything he was under a duty to disclose. Specifically, contrary to the government's brief, the indictment does not charge respondent with having "feigned" interest in the Pillsbury litigation or of having done anything else that induced either Grand Met or Dorsey to act to its detriment. Instead, the securities fraud charged in the indictment is that respondent breached his fiduciary duty to Grand Met and Dorsey by "misappropriat[ing] the information relating to Grand Met's future tender offer for Pillsbury common stock and purchas[ing] Pillsbury common stock and call options on Pillsbury common stock." (JA 16 ¶3). *See also id.* ¶4 (charging that respondent "did use and employ manipulative and deceptive devices and contrivances" by "purchasing" Pillsbury securities). The indictment charges breach of fiduciary duty and conversion. It does not charge deception, *i.e.*, misrepresentation or nondisclosure as defined by this Court for purposes of §10(b).

The instructions given to the jury echoed the claims in the indictment. (JA 194).[23] While the instructions charged that respondent must have acted "with the intent to defraud," nowhere do they tell the jury what deception under §10(b) and Rule 10b-5 means. (*See* JA 195-96).[24] Essentially, the jury was instructed that

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[23] With respect to the counts alleging violation of §10(b), the jury was instructed:

> In Counts 21 through 37, it is claimed that O'Hagan used the information which came to him to work a fraud on Grand Met and Dorsey and Whitney. Now, according to the indictment, he worked this fraud *by purchasing* Pillsbury stock and options *while he was in possession of* material, nonpublic information concerning Grand Met's upcoming tender offer for Pillsbury securities. (JA 194).

[24] The jury was charged that it had to find that respondent had "misappropriated" material, nonpublic information. "Misappropriation" was

it could convict respondent under §10(b) and Rule 10b-5 if it found that he had breached a fiduciary duty to Grand Met or Dorsey by trading in Pillsbury securities while in possession of nonpublic information obtained from either of them. The district court's instructions, like the indictment itself, are defective because they failed to include the separate element of deception as defined in *Santa Fe*, *Dirks*, and *Central Bank*. A conviction cannot be upheld on the basis of a legal theory reflected in neither the indictment nor the jury charge. *See Rewis v. United States*, 401 U.S. 808, 814 (1971).

### 2. The misappropriation theory does not satisfy the "in connection with" requirement of §10(b).

Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security" "any manipulative or deceptive device or contrivance." There is no evidence in this case that respondent used deception in[25] the purchase or sale of any security. Respondent made no representations to the Pillsbury shareholders whose shares he purchased. Because he owed no fiduciary duty to Pillsbury shareholders, he had no duty to disclose the information he allegedly had regarding an unknown client's interest in Pillsbury.

The government contends, however, that it can satisfy the "in connection with" requirement by proving that respondent breached a fiduciary duty to the outside source of the information and, thereafter, used the fruits of that breach to purchase securities. In permitting liability to be premised on a showing of "fraud on the source" instead of fraud on a person involved in the purchase or sale of securities, the misappropriation theory transforms §10(b)

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never defined by the court to require deception. Indeed, the jury was instructed that they could find deception if they found that respondent had used material information which he knew was given to him in confidence. (*See* JA 200 (defining intent to deceive, manipulate, or defraud)).

[25] This Court has, on other occasions, suggested that "in" is a reasonable substitute for phrases such as "in regard to" or "in connection with." *See Dunn*, 117 S.Ct at 916; *United States v. Naftalin*, 441 U.S. 768, 773 & n.4.



from a statute focused on the relation between parties to a securities transaction into one which "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in [the] transaction." *O'Hagan*, 92 F.3d at 618. Analytically, the flaw in the misappropriation theory is clear: the theory "artificially divides into two discrete requirements -- a fiduciary breach and a purchase or sale of securities -- the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction." *Bryan*, 58 F.3d at 950.[26] In so doing:

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[26] The government has suggested that Grand Met fits within the category of persons referred to in *Bryan* as those "intimately linked with or affected by a securities transaction." That this is not the case is clear from language elsewhere in *Bryan*. The *Bryan* court described what it meant by persons "closely linked to a securities transaction" by reference to *Blue Chip Stamps*. 58 F.3d at 948. In *Blue Chip Stamps*, the Court had acknowledged that other persons beyond purchasers and sellers may be damaged by violations of Rule 10b-5. 421 U.S. at 743. As noted in *Bryan*, however, the *Blue Chip Stamps* Court included in this category "potential purchasers of shares" and "actual shareholders" ***"who decide not to purchase or sell due to material misrepresentations or omissions"*** and "shareholders, creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities." *Id.* at 737-38 (emphasis added). The *Bryan* court also noted the protection afforded by §17(a) of the 1934 Act to "financial intermediaries such as stockbrokers, because their welfare is 'inextricably linked' to that of investors." 58 F.3d at 948. Grand Met does not fit within the class of investors or those acting as agents for investors referenced by *Bryan*. Any argument that the court intended by its reference to persons "affected by a securities transaction" to include within the class of persons protected by §10(b) those contemplating a future tender offer is defeated by the court's unequivocal assertion that "Section 10(b) is not concerned with the general fairness of securities transactions themselves, so long as there is no evidence of deception in connection with a securities transaction, in the form of material misrepresentations or omissions made to persons connected with a securities transaction." *Id.* at 952.

The analysis in *Bryan* of persons protected by §10(b) is consistent with the requirement that deception involve the inducement of action or inaction; in this case, the inducement of action or inaction by someone -- be it a purchaser,

> the theory effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived, allowing conviction not only where the "defrauded" person has no connection with a securities transaction, but where no investor or market participant has been deceived. In allowing the statute's unitary requirement to be satisfied by any fiduciary breach (whether or not it entails deceit) that is followed by a securities transaction (whether or not the breach is of a duty owed to a purchaser or seller of securities, or to another market participant), the misappropriation theory transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships.

*Id.*

In its attempt to transform §10(b) from a statute principally concerned with the protection of purchasers and sellers of securities, or other market participants,[27] into one which seeks to punish those who may have engaged in fraudulent conduct outside the securities market, the misappropriation theory broadens §10(b)

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seller, broker, or another investor -- "in connection with the purchase or sale of any security." Neither Dorsey nor Grand Met was a participant in respondent's securities transaction and neither was induced to do anything "in connection with" the purchase or sale of securities. The government's suggestion that Grand Met should be treated as a market participant because it was a "bidder" for Pillsbury and "poised to become a 'market participant,'" (Govt. Br. at 25), misstates the record. *See* pp. 5- 7, *supra*.

[27] The government cites *Naftalin* as evidence that this Court has, in the context of a statute not here at issue, construed fraud "in" a securities transaction to encompass more than fraud on investors. (Govt. Br. at 22-23). *Naftalin* provides no support for the government's contention that a breach of duty to someone *other than a participant in a securities transaction* can give rise to liability under §10(b), however, since, in *Naftalin*, the brokers who were allegedly deceived *were* participants in the securities transactions at issue. In this case, by contrast, neither Grand Met nor Dorsey was a participant in respondent's securities transactions.



beyond the plain language of the statute in a manner inconsistent with the decisions of this Court.

In *Santa Fe*, the Court refused an invitation to interpret the statute by reference to "business ethics." The Court rejected the argument that a breach of a fiduciary duty by the majority shareholders to deal fairly with minority shareholders was sufficient to establish liability under §10(b) absent any evidence of fraud in a securities transaction. 430 U.S. at 476-77. Later, in *Aaron v. SEC*, 446 U.S. 680 (1980), the Court declined the SEC's invitation to interpret §10(b) by considering the impact of the challenged conduct on investors. The Court reaffirmed that the touchstone of liability was not whether investors suffered losses as a result of any conduct by the defendant but whether the conduct was deceitful or fraudulent. *Id.* at 685. *See also Ernst & Ernst*, 425 U.S. at 197-99 (rejecting SEC's argument in amicus brief that the Court should predicate §10(b) liability on an "effects" oriented approach).

In *Chiarella*, the Court affirmed that it is the relation between the insider -- a fiduciary to the corporation -- and the corporation's shareholders that triggers the disclosure obligation. Noting that the common law did not recognize a duty to equalize information through disclosure absent a relationship of trust and confidence, the Court delineated the test for actionable fraudulent nondisclosure under §10(b):

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*.

445 U.S. at 230 (emphasis added). *See also id.* at 227-28, 232-33.

*Dirks* reaffirmed the principle that "[a] duty [to disclose] arises from the relationship between parties ... and not merely from one's

ability to acquire information because of his position in the market." 463 U.S. at 657-58.[28] Finally, in *Central Bank*, the Court again emphasized that the focus of §10(b) is on fraud directed toward purchasers or sellers of securities, or, at most, other market participants, noting that: "the broad congressional purpose" behind §10(b) is "to protect investors from false and misleading practices that might injure them." 114 S.Ct. at 1446. Consistent with *Dirks* and *Central Bank*, "a violation [of §10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud *investors.*'" *Dirks*, 463 U.S. at 663, n.23 (emphasis added).

Taken together, *Central Bank*, *Chiarella*, *Dirks*, and *Santa Fe* hold that §10(b) challenges may be brought only with respect to conduct prohibited by the text of the statute; that the deception proscribed in §10(b) is the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose; and that the deception to which the statute is directed is deception intended to induce action or inaction by purchasers and sellers of securities, or other market participants, involved in a particular securities transaction.[29] *See Bryan*, 58 F.3d at 944.

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[28] Although the quoted excerpt from *Dirks* references only "parties" and not "parties to a securities transaction," the Court earlier in the opinion had clarified that the duty to disclose was meant to be determined in the transactional context: "We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" 463 U.S. at 654 (quoting *Chiarella*, 445 U.S. at 232).

[29] Those courts that have adopted the misappropriation theory have reconciled the theory with the statute's requirement that there be deception "'in connection with the purchase or sale' of any security," by relying on dicta in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-15 (1971), for the proposition that the deception need only "touch" a securities transaction and need not be upon a party interested in the transaction. The Eighth Circuit exposed the weakness of this argument, however, when it:

> decline[d] to ascribe such broad meaning to this single passage from *Bankers Life*. Such a sweeping interpretation appears to be inconsistent with the Court's statement in the immediately previous paragraph of *Bankers Life* that "we read §10(b) to mean that Congress meant to bar deceptive devices and contrivances ***in the purchase or sale of securities***." More importantly, the victim of the fraud in *Bankers Life* was a seller of securities who was "injured as an investor." Finally, if this passage held the all-encompassing meaning the government attributes to it, then we cannot fathom how the defendants in the subsequent *Chiarella*, *Dirks*, and recently *Central Bank* cases escaped §10(b) liability because each engaged in acts that "touched" the securities transaction.

92 F.3d at 619-20 (internal citations omitted) (emphasis added).

[30] At common law, one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose. *Restatement (Second) of Torts* §551.



The misappropriation theory cannot be reconciled with the language of §10(b) as interpreted by this Court. Nor, as noted in *Bryan*, can the theory be reconciled with the "principles that inform interpretation of the securities fraud provisions." 58 F.3d at 950. As this Court has stated, the securities industry in general, including specifically the field of securities transactions within §10(b), is "'an area that demands certainty and predictability,'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business," are to be avoided. *Central Bank*, 114 S.Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). The misappropriation theory eviscerates the predictability of §10(b) by ignoring the settled rule, grounded in common law,[30] that the duty to disclose in the context of a securities transaction arises from a fiduciary relationship between participants in a securities transaction. In its place, the government urges a "theory" that regulates the relationship of parties to a securities transaction based on conduct occurring wholly outside the relationship.

Moreover, the misappropriation theory is unprincipled in application. Whatever principled basis there might be under a parity-of-information theory for precluding *all* trading on the basis of unlawfully-obtained material, nonpublic information, there can be no principled basis for precluding trading on the basis of nonpublic information unlawfully obtained through a breach of

fiduciary duty but permitting such trading if the information is obtained through theft or some other unlawful conduct. Yet, that is exactly what the misappropriation theory does. The government seeks, in this case, to punish respondent for allegedly trading in securities on the basis of confidential information obtained in breach of a fiduciary duty to his law firm and its client. Had a burglar simply broken into Grand Met's home office and stolen the same information, however, he would not be liable under the misappropriation theory, because he would not even arguably have engaged in deception within the meaning of §10(b). Yet the result of the wrongful conduct, in both cases, would be precisely the same.

In abandoning the textual requirement that deception for purposes of §10(b) occur between parties to a securities transaction -- *i.e.*, "in connection with the purchase or sale of any security" -- the misappropriation theory slips its statutory tether and, thus unleashed, invites "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5.'" *Central Bank*, 114 S.Ct. at 1454 (quoting *Blue Chip Stamps*, 421 U.S. at 755). *See also Chestman*, 947 F.2d at 567 ("[F]iduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts."). Because it lacks textual foundation, the misappropriation theory has proven unpredictable and inconsistent in its application by the courts that have adopted it. *See Bryan*, 58 F.3d at 951-52 (describing the myriad fiduciary situations in which the misappropriation theory has been applied and noting that "[i]t would be difficult to overstate the uncertainty that has been introduced into the already uncertain law governing fraudulent securities transactions through adoption of the misappropriation theory, with its linchpin the breach of a fiduciary duty"); *O'Hagan*, 92 F.3d at 622 n.14 (describing, as the "paradigmatic example of the attenuated circumstances in which a §10(b) conviction based on the misappropriation theory has been obtained" the decision in *United States. v. Willis*, 737 F. Supp. 269 (S.D.N.Y.), involving the alleged breach of a physician-patient duty); Harold S.



Bloomenthal, et al. *Securities Law Handbook* 1179 (1997) (The misappropriation theory "as the basis for insider trading liability is a theory in search of a rationalization.").[31] In the words of *Bryan*, "[a]bsent clearly defined rules, investors find themselves the targets of ad hoc decisionmaking or pawns in an overall litigation strategy known only to the SEC." 58 F.3d at 951. Not only is such decisionmaking antithetical to the policy of predictability in the securities arena, but also for reasons set forth below, such decisionmaking, when it constitutes the basis for a *criminal* prosecution, violates principles of due process.

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[31] Other commentators have similarly criticized the misappropriation theory. *See, e.g.*, Alan R. Bromberg & Lewis D. Lowenfels, *Bromberg and Lowenfels on Securities Fraud & Commodities Fraud* (2d ed. 1994) §7.5 (513) at 7:241-42 (concluding that "[w]e think the misappropriation theory as a part of securities law defies common sense. ... It is a Rube Goldberg contraption for the lower courts and the SEC to find a roundabout violation when the Supreme Court has rejected a direct violation.... As securities law, the theory is foolish in enforcement actions and absurd in private actions."); Michael P. Kenny & Theresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 Alb. L. Rev. 139 (1995) ("The misappropriation theory goes wrong because it is untethered to the words of the statute. Free of textual constraint, the theory has been applied to conduct that cannot credibly be considered fraud, much less fraud in a securities transaction."); Sean P. Leuba, *The Fourth Circuit Breaks Ranks in United States v. Bryan: Finally, a Repudiation of the Misappropriation Theory*, 53 Wash. & Lee L. Rev. 1143, 1208 (1996) ("[T]he misappropriation theory contradicts precedent, protects relationships instead of investors, requires the evaluation of vague concepts of fiduciary duties, and does not provide clear guidelines for prospective enforcement."); Milton V. Freeman, *The Insider Trading Sanctions Bill - A Neglected Opportunity*, 4 Pace L. Rev. 221, 228 (1984) (The author of this article, a co-draftsman of Rule 10b-5 in 1942 in his capacity as Assistant Solicitor of the SEC, observes that "The SEC is so accustomed to the use of Rule 10b-5 as a be-all and end-all that it has not adequately recognized that the problem it is facing [outsider trading] is of a different character, larger than can readily be managed within that narrow compass," and urges the adoption of specific legislation addressed to the problem of outsider trading.).

**B. Criminal Convictions Under The Misappropriation Theory Violate Due Process Because An Uncodified "Theory" Cannot Provide Adequate Guidance As To What Conduct Is Illegal.**

As is clear from the preceding section, the misappropriation theory cannot be supported by reference to the text of §10(b) and, for that reason alone, the court of appeals' decision should be upheld. Moreover, even if §10(b) *could* be construed broadly to encompass the misappropriation theory, the application of an undefined "theory" to respondent's conduct in this case would violate due process and transgress the doctrines of fair notice, lenity and strict construction, and, thus, such a construction should be avoided. *Edward J. DeBartolo Corp. v. Florida Gulf Coast Building & Constr. Trades Council*, 485 U.S. 568, 575 (1988) ("[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress."); *Ashwander v. TVA*, 297 U.S. 288, 348 (1936) (Brandeis, J., concurring).

It is axiomatic that "[d]ue process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal, for 'no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.'" *Buckley*, 424 U.S. at 77 (quoting *United States v. Harriss*, 347 U.S. 612, 617 (1954)); *see also Kolender v. Lawson*, 461 U.S. 352, 357 (1983). As this Court stated in *Grayned, supra*: "because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." 408 U.S. at 108; *see also United States v. Aguilar*, __ U.S. __, 115 S. Ct. 2357, 2362 (1995) ("We have traditionally exercised restraint in assessing the reach of a federal criminal statute, both out of deference to the prerogatives of the Congress, and out of concern that 'a fair warning should be given to the world in language that the common world will understand of what the law intends to do if



a certain line is passed.'") (citations omitted); *Chiarella*, 445 U.S. at 235 n.20 ("[A] judicial holding that certain undefined activities 'generally are prohibited' by §10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity.").

The misappropriation theory offends due process because it lacks definiteness. Released from the statutory constraints which once restricted §10(b)'s reach to conduct involving participants in a securities transaction, the misappropriation theory now extends the statute to encompass any breach of fiduciary duty, the fruits of which can be shown, however tenuously, to have "touched" a subsequent securities transaction.[32] The protean nature of the misappropriation theory sows confusion as to what constitutes lawful conduct,[33] and invites ad hoc decisionmaking.

The SEC has indicated its preference for this kind of case-by-case approach and has discouraged efforts by Congress to provide a clear articulation of the parameters of §10(b) and insider trading.[34] However, ad hoc decisionmaking is the antithesis of the

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[32] The government's purported "clarification" of the contours of the misappropriation theory in its brief underscores the fact that the theory has heretofore lacked *any* defined boundaries. Even this attempt to define the boundaries of the misappropriation theory, however, is not adequate to give notice as to what conduct is covered under this version of the theory and what is not; as the government concedes in its brief, it still must define the reach of the newly formulated theory on a case-by-case basis. (*See* Govt. Br. at 24 n.13).

[33] *See* Brief of the Association for Investment Management and Research as *amicus curiae* in support of the government in this matter, stating that uncertainty over the scope of the misappropriation theory chills the free flow of information. *See also Bryan*, 58 F.3d at 951, in which Judge Luttig noted that:

> Thus far, the misappropriation theory has been invoked by federal prosecutors and securities regulators to regulate such diverse relationships as that between an employer and employee, between an employer and an employee's tippees, between a newspaper and its reporters, between an employer and a former employee, between a psychiatrist and his patient, between a husband and wife, between a father and son, and, as in [*Bryan*], between a government official and his constituency. (citations omitted).

[34] In 1984, the SEC testified *against* a bill introduced specifically as a codification of the misappropriation theory. As described by Senator D'Amato,

due process protection in criminal cases. *United States v. Kozminski*, 487 U.S. 931, 951 (1988) (the Constitution does not

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the bill's sponsor and chairman of the Senate subcommittee on securities, the proposed legislation:

> would abandon the rule 10b-5 requirement that the SEC prove fraud and show that the trader intended to deceive or defraud investors to whom he owed a duty. Instead, it would create a new section in the securities laws to supplement rule 10b-5 which would simply proscribe the unfair use of inside information. The SEC would no longer be required to prove that the insider had a special relationship with the person he was trading with or that the insider intended to defraud the other party.

The Insider Trading Sanctions Act of 1983: Hrgs. on H.R. 559 before Subcom. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 1 (April 3, 1984) ("1984 Hrgs."). John Shad, chairman of the SEC, and John Fedders, director of the SEC's Division of Enforcement, testified regarding the proposed legislation. Mr. Fedders noted six reasons supporting the passage of legislation defining insider trading. Among them: (1) "[B]y defining insider trading, Congress would establish the parameters of the illegal conduct . . . *The definition would permit Congress to prohibit the conduct it wants to make illegal.*" and (2) "a definition would permit Congress to clarify the law for the benefit of the investing public as well as the Commission and criminal prosecutors....Commentators have said that uncertainty remains in the law of insider trading ... *[J]ustice is too important to be left solely to judges and lawyers acting on a case-by-case ad hoc basis. Congress is our lawmaker. Clarification of the law by Congress would permit investors to chart their course of conduct confident in their obligations.*" 1984 Hrgs. at 35 (emphasis added). *See also* Testimony of SEC chairman Shad: "I think everyone who has addressed this area initially feels intuitively and emphatically that we should have a definition [of insider trading]." *Id.* at 57.

Having identified the need for clarification in the law, however, the SEC ultimately opposed enactment of legislation defining and codifying the misappropriation theory because "a definition of insider trading for purposes of enforcement actions under rule 10b-5 may reduce the Commission's flexibility to prosecute evolving types of conduct." In Fedders' words, "drafting a comprehensive definition is enormously difficult" while the existent "antifraud provisions work so well" because they "provide the Commission with the flexibility on a case-by-case basis." *Id.* at 37. Respondent respectfully submits that the flexibility desired by the SEC constitutes ambiguity in the context of a criminal prosecution in contravention of the fair notice requirement of the due process clause.



"tolerate the arbitrariness and unfairness of a legal system in which the judges would develop standards for imposing criminal punishment on a case-by-case basis"). Moreover, defining the misappropriation theory on an essentially ad hoc basis amounts to a retroactive application of the law and, because a defendant is not provided fair notice, also offends the *ex post facto* clause. *Lynce v. Mathis*, __ U.S. __, 117 S.Ct. 891, 896 (1997) (noting that one of the central concerns of the ex post facto clause is "the lack of fair notice" as to what is illegal or as to the level of punishment ascribed to conduct). Flexible interpretations of regulatory statutes that incrementally expand a statute beyond its original purposes, although perhaps defensible in occasional and highly unusual civil enforcement contexts, are impermissible in criminal prosecutions, and, for that reason, respondent's conviction under the misappropriation theory cannot stand. *Crandon v. United States*, 494 U.S. 152, 158 (1990) (When applying *criminal* statute, "it is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage.").

## II. THE SEC EXCEEDED ITS RULEMAKING AUTHORITY WHEN IT PROMULGATED RULE 14e-3

Pursuant to authority conferred by Congress, the SEC has the power to promulgate rules in connection with its responsibility to oversee the securities markets. 15 U.S.C. § 79t. However, the power to make rules "is not the power to make law -- for no such power can be delegated by Congress -- but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Manhattan General Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936); *see also Ernst & Ernst*, 425 U.S. at 214 (1976). A regulation that exceeds these mandates "operates to create a rule out of harmony with the statute [and] is a mere

nullity." *Manhattan General*, 297 U.S. at 134; *see also Securities Indus. Ass'n v. Board of Governors*, 468 U.S. 137, 143 (1984).[35]

The SEC promulgated Rule 14e-3 within months of this Court's opinion in *Chiarella*, *supra*, in a deliberate attempt to overrule *Chiarella*'s mandate that common law concepts of fraud must be proven for a §10(b) violation. Rule 14e-3 departs from its statutory mandate and established law by imposing liability in the absence of any fiduciary breach, and thereby criminalizes conduct that the SEC, and not Congress, decides is "fraudulent." Rule 14e-3 also improperly extends §14(e) to prohibit trading in advance of a tender offer, without providing fair notice of when a violation occurs and without requiring scienter. Accordingly, the SEC exceeded its rulemaking authority and Rule 14e-3 is invalid.

### A. The Language Of §14(e) Constrains The SEC's Rulemaking Authority By The Common Law Definition Of Fraud.

Because the validity of Rule 14e-3 turns on the scope of conduct that may be regulated by §14(e), the plain language of the statute is

[35] While deference is to be accorded an interpretation of a statute provided by an agency charged with its enforcement, *Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984), such deference is "improper" if "the statute, as a whole, clearly expresses Congress' intention." *Dunn*, 117 S.Ct. at 920 n.14 (citing *Dole v. Steelworkers*, 494 U.S. 26, 42 (1990)); *see also Presley v. Etowah County Comm'n*, 502 U.S. 491, 508 (1992) ("As in other contexts in which we defer to an administrative interpretation of a statute, we do so only if Congress has not expressed its intent with respect to the question."); *IBT v. Daniel*, 439 U.S. 551, 566 n.20 (1979) ("[D]eference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history.") Accordingly, this Court has not hesitated to reject SEC interpretations of provisions of the Securities Acts which are inconsistent with the statute. *See, e.g., Aaron*, 446 U.S. at 694 n.11 (1980); *SEC v. Sloan*, 436 U.S. 103, 199-21 (1978); *Chris-Craft Industries, Inc.*, 430 U.S. at 41 n.27; *Ernst & Ernst*, 425 U.S. at 213-14; *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 n.25 (1975); *Blue Chip Stamps*, 421 U.S. at 759 n.4; *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 425-27 (1972).



controlling. *Central Bank*, 114 S.Ct. at 1447. The pertinent language of §14(e) is virtually identical to the language of §10(b):

| Section 14(e) | Section 10(b) |
|---|---|
| It shall be unlawful for any person * * * *to engage in any fraudulent, deceptive, or manipulative acts or practices*, in connection with any tender offer * * * The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative. 15 U.S.C. §78n(e). | It shall be unlawful for any person * * * *to use or employ*, in connection with the purchase or sale of any security * * * *any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. §78j. |

Section 14(e) is a "'broad antifraud prohibition,' modeled on the antifraud provisions of §10(b) of the [Exchange] Act and Rule 10b-5." *Schreiber*, 472 U.S. at 10 (citation omitted). Sections 14(e) and 10(b) both proscribe "deceptive" and "manipulative" acts, and both authorize the SEC to implement the provisions by "rules and regulations." The language of §14(e) differs only in its specific prohibition of "fraudulent" activities, and thus emphasizes fraud as the essence of a violation of §14(e). *See id.* at 10 n.10. Given the textual similarities between two sections of the same statutory enactment, the case law construing §10(b) cannot be ignored when interpreting §14(e). *See Gustafson v. Alloyd Co.*, 115 S.Ct. 1061, 1066 (1995) ("In seeking to interpret the term 'prospectus,' we adopt the premise that the term should be construed, if possible, to give it a consistent meaning throughout the Act. That principle follows from our duty to construe statutes,

not isolated provisions.") (citations omitted); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 297 (1993).

In *Schreiber*, 472 U.S. at 5-6, this Court determined the meaning of the term "manipulative" under §14(e) by looking to its prior decisions construing "manipulative" under §10(b) as well as the common law definition. In rejecting the view that "manipulative" encompasses any "unfair" conduct, the Court stated that §14(e) is not "an invitation to the courts to oversee the substantive fairness of tender offers." *Id.* at 12. Rather, as the Court held, the term "manipulative" required misrepresentation or nondisclosure in conformity with §10(b). *Id.* at 7-8.

It is beyond dispute that fraud under §10(b) requires proof of a breach of fiduciary duty. *Chiarella*, 445 U.S. at 228; *Dirks*, 463 U.S. at 656. In setting the contours of fraud, *Chiarella* returned to common law principles, stating:

> One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

445 U.S. at 228 (quoting *Restatement (Second) of Torts* §551(2)(a)). *Chiarella* explicitly rejected the SEC's position -- replicated here with respect to tender offers -- that any trading on material nonpublic information is fraudulent because it gives certain buyers or sellers an unfair advantage. *Id.* at 232. *Chiarella* found that the imposition of such a broad duty to disclose in the absence of any fiduciary relationship would "depart radically from ... established doctrine ... [and] should not be undertaken absent some explicit evidence of congressional intent." *Id.* at 233. *Dirks* confirmed that fraud under §10(b) requires a showing that the accused violated an affirmative duty to speak, and again rejected



the SEC's request to adopt a parity-of-information rule. 463 U.S. at 654.[36]

In accordance with *Schreiber*, *Chiarella* and *Dirks*, the term "fraudulent" under §14(e) must be accorded its common law definition requiring a breach of duty. *See also United States v. Turley*, 352 U.S. 407, 411 (1957) (explaining that "where a federal criminal statute uses a common-law term of established meaning without otherwise defining it, the general practice is to give that term its common-law meaning"). Accordingly, as the court below properly found, the SEC exceeded its statutory mandate when it promulgated Rule 14e-3, which requires no such breach.

The government argues that the second sentence of §14(e), added by Congress in 1970, grants the SEC broader rulemaking powers than does §10(b), in that the use of the word "define" indicates that the SEC can redefine and set forth the meaning of fraud under the statute.[37] The plain language of this rulemaking

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[36] While §10(b) does not contain the term "fraudulent," it is well settled that "what it catches must be fraud." *Chiarella*, 445 U.S. at 235. The fact that the principles announced in *Chiarella* and *Dirks* were based on the common law meaning of fraud rather than the text of §10(b) indicates further that these principles apply with equal force to §14(e). *See Chestman*, 947 F.2d at 586 (Mahoney, J., dissenting) ("No reason appears why this generally applicable rule of law, not derived in any way from the language or history of section 10(b) and rule 10b-5, should have definitive force in the construction and interpretation of those provisions, but none where section 14(e) and rule 14e-3(a) are concerned."). As the court below noted, "[i]t is inexplicable to us why this Restatement rule [cited in *Chiarella*], should have definitive force in the §10(b) context but not in the §14(e) context, especially in light of the fact that the two sections are part of the same statutory scheme." 92 F.3d at 626.

[37] The government argues that the enabling provision of §14(e) was modeled after the rulemaking language of §15(c)(2) of the Exchange Act, 15 U.S.C. §78o(c)(2), which prohibits fraudulent broker and dealer practices. (Govt. Br. at 39). §15(c)(2) does not permit the SEC to redefine fraudulent practices any more than §14(e) does. The government points to four rules that had been promulgated under §15(c)(2) as of 1970 which identify "a number of practices that had not constituted common law fraud." (Govt. Br. at 39 n.22). Not one of those rules prohibits trading on material information in the absence of fiduciary breach, and the validity of those rules is neither before this Court nor relevant to the question of Rule 14e-3's validity.

provision, however, directs the SEC to define "such acts and practices *as are fraudulent*, deceptive or manipulative," not to redefine "fraud." The use of the qualifying phrase "as are fraudulent" indicates that the SEC is authorized to identify and proscribe specific acts within the established meaning of fraud, not to determine what elements comprise fraud in the securities context. The government's interpretation would render the use of the phrase "as are fraudulent" superfluous, and the meaning of the word "fraudulent" irrelevant. *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting); *cf. Dunn*, 117 S.Ct. at 917 ("[L]egislative enactments should not be construed to render their provisions mere surplusage.").

The very argument the government is now making concerning the enabling provision was explicitly rejected in *Schreiber* with regard to the term "manipulative":

> In adding the 1970 amendment, Congress simply provided a mechanism for defining and guarding against those acts and practices which involve material misrepresentation or nondisclosure. The amendment gives the Securities and Exchange Commission latitude to regulate nondeceptive activities as a "reasonably designed" means of preventing manipulative acts, *without suggesting any change in the meaning of the term "manipulative" itself.*

472 U.S. at 11 n.11 (emphasis added).[38] It is difficult to discern why Congress would intend to change the meaning of the term "fraudulent" but not the meaning of the term "manipulative" in the same statutory provision, particularly since "[a]ll three species of

[38] The government partially quotes this language from *Schreiber* arguing that the phrase "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts" supports its position, while conveniently ignoring the remaining language of the same sentence: "without suggesting any change in the meaning of the term 'manipulative' itself." (Govt. Br. at 40). As the court below found, "[p]roperly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." 92 F.3d at 627.



misconduct, i.e., 'fraudulent, deceptive, or manipulative,' listed by Congress are directed at failures to disclose." *Id.* at 8.[39]

Because the "explicit evidence of congressional intent" required for the SEC's dramatic departure from established doctrine, *Chiarella*, 445 U.S. at 233, is not manifested by §14(e), Rule 14e-3 is an invalid exercise of the SEC's statutorily-defined authority -- especially in the criminal context: "This is a truly breathtaking construction of a delegation to the SEC, we must bear in mind, of the authority to prescribe a federal felony." *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting).[40]

### B. The Legislative History Of Section 14(e) Does Not Indicate That Congress Intended To Authorize The SEC To Redefine Fraud.

Because the text of §14(e) does not permit the SEC to redefine fraud, "that conclusion resolves the case." *Central Bank*, 114 S.Ct. at 1448; *see also Dunn*, 117 S.Ct. at 921. Nevertheless, the Government suggests that the legislative history of §14(e), which this Court has recognized as "sparse," *Schreiber*, 472 U.S. at 11, supports its interpretation that the SEC is authorized to depart from the common law and proscribe conduct in the absence of fiduciary breach.

[39] In support of its position, the government relies primarily on the Second Circuit's decision in *Chestman*. In *Chestman*, however, the court found that Rule 14e-3 was valid because, notwithstanding the text of §14(e), the rule retained "a *close nexus* between the prohibited conduct and the statutory aims." *Id.* at 560 (emphasis added). This holding is untenable under *Central Bank*, which made clear that the substantive text of the statute determines the scope of prohibited conduct. 114 S.Ct. at 1447. In addition, *Chestman* improperly interpreted subsequent congressional enactments in 1984 and 1988 as support for the status quo. As explained *infra*, this too is impermissible under *Central Bank*, 114 S.Ct. at 1453.

[40] The government suggests that Rule 14e-3 represents good policy because "the difficulties of establishing such a breach [of fiduciary duty] may permit sophisticated insider trading to go unpunished." (Govt. Br. at 44). Policy arguments, however, are "best addressed to the Congress, not the courts." *Dunn*, 117 S.Ct. at 921.

As a result of the increased frequency of cash tender offers in the mid-1960s,[41] which were unregulated and conducted in virtual secrecy,[42] Congress passed the Williams Act in 1968. Two years later, it enacted a rulemaking provision to "give the Commission rulemaking power with respect to fraudulent, deceptive, and manipulative techniques in tender offers." Statement by Senator Williams, 116 Cong. Rec. 3024 (1970). Nowhere does the record show that Congress intended that the SEC redefine fraud and regulate insider trading in the absence of fiduciary breach.[43]

The Government points to one memorandum sent to Congress by the SEC which identified trading on the basis of material facts concerning a tender offer as a possible "problem area" where the proposed rulemaking powers might be invoked. (Govt. Br. at 43.) Because the memorandum made no mention of fiduciary breach, the government argues, Congress must have intended to authorize the SEC to redefine fraud. *Id.* This memorandum, however, was not prepared by Congress. "If legislative history is to be considered, it is preferable to consult the documents prepared by

[41] The number of tender offers increased from 8 in 1960 to over 100 in 1966. *See* Janell M. Kurtz & Bradley J. Sleeper, *Fraud Liability for Outsider Trading: SEC Rule 14e-3 in Limbo*, 29 Am. Bus. L. J. 691, 693 (1992).

[42] Prior to 1968, the federal securities laws required full disclosure of information to investors in proxy contests, 15 U.S.C. §78n, and stock-for-stock exchanges, 15 U.S.C. §77e, but not cash tender offers.

[43] On the contrary, given that the 1970 amendment was passed "in the early years of the tender offer phenomenon and its attendant regulation. ... the plain meaning of the dispositive language is that the SEC is empowered to identify and regulate, in this (then) novel context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive, or manipulative,' but not to redefine the categories themselves." *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting). Indeed, the SEC did not even declare its view that "insider trading" constituted a violation of §10(b) until its 1961 decision in *In re Cady, Roberts & Co*, 40 S.E.C. 907 (1961). The first court to even consider the theory was the Second Circuit in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). There was hardly a body of case law governing insider trading in 1970, and there is no indication Congress intended to regulate such trading under §14(e), much less allow the SEC to redefine fraud to cover trading of "outsiders" absent any fiduciary breach.



Congress when deliberating." *Gustafson*, 115 S.Ct. at 1072; *see also Piper*, 430 U.S. at 31 n.20 ("Remarks ... made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill are entitled to little weight.") (quoting *Ernst & Ernst*, 425 U.S. at 204 n.24). Furthermore, this memorandum was sent to Congress *after* the hearings regarding the rulemaking provision had concluded, and there is no evidence that any Congressman even read the memorandum. "Material not available to the lawmakers is not considered, in the normal course, to be legislative history." *Gustafson*, 115 S.Ct. at 1071.[44]

### C. Rule 14e-3 Improperly Extends §14(e) To Prohibit Trading In Advance Of A Tender Offer, Without Providing Notice As To When A Violation Occurs And Without Requiring Scienter.

Section 14(e) prohibits fraudulent acts "in connection with a tender offer." The plain language of the statute indicates that violations of §14(e) cannot occur unless and until a tender offer is made. This reading is consistent with Congress' intent to address the exigencies of tender offer situations where shareholders are often called upon to act quickly: "The sole purpose of the Williams Act was the protection of investors *who are confronted with a tender offer*." *Piper*, 430 U.S. at 35 (emphasis added); *see also Schreiber*, 472 U.S. at 8 ("The purpose of Williams Act is to ensure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without

[44] Even assuming Congress considered the memorandum, the specified "problem area" is too broad to provide any delineation of the scope of the rulemaking provision. In addition to failing to mention breach of duty, the memorandum fails to mention the source of the individual's discovery. Hence this memorandum, as interpreted by the government, authorizes the prosecution of a person who trades after observing heavy trading in a target company's stock. *Chestman*, 947 F.2d at 585 (Mahoney, J., dissenting); *see also* William J. Cook, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 Stetson L. Rev. 171, 193-94 (1992).

adequate information."); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975). Rule 14e-3 exceeds its statutory mandate by criminalizing conduct "[i]f any person *has taken a substantial step or steps to commence*, or has commenced, a tender offer." 17 C.F.R. 240.14e-3(a) (emphasis added). Accordingly, Rule 14e-3 is invalid.[45]

The government's extension of §14(e) to include pre-offer conduct has resulted in an unreasonable rule that fails to comport with due process on two levels. First, Rule 14e-3 does not define "substantial steps," and thus fails to give fair notice as to when, in advance of a tender offer, a violation of §14(e) occurs. Conflicting decisions among the lower courts have only furthered the confusion. *Compare Frankel v. Slotkin*, 705 F. Supp. 105, 109 (E.D.N.Y. 1989) (dismissing claim under §14(e) where three months had elapsed between receipt of confidential information and the tender offer); *with SEC v. Mayhew*, 916 F. Supp. 123, 125, 130 (D. Conn. 1995) (substantial steps were taken two months prior to merger announcement when companies jointly retained a business consulting firm and individually retained bankers and

[45] Prior to the enactment of Rule 14e-3, the majority of lower courts held that that the duty to disclose under §14(e) was not triggered until a tender offer was made or, in the merger context, when an agreement in principle had been reached. *See, e.g., Sanders v. Thrall Car Mfg.*, 582 F. Supp. 945, 966 (S.D.N.Y. 1983) (§14(e) was "never intended to serve an omnibus police function, but rather [was] intended to ensure full and fair disclosure in the more limited context of *the offer itself*") (emphasis added); *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976); *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075, 1084-85 (5th Cir. 1970); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1318 (W.D. Mich. 1978); *Crane Co. v. Anaconda Co.*, 411 F. Supp. 1208, 1210 (S.D.N.Y. 1975). The only "pre-offer" conduct held to fall within the purview of §14(e) were statements made by the offeror or target company after a *public announcement* of a forthcoming offer (but prior to the actual effective date of the offer). *See Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980); *Applied Digital Data Sys., Inc. v. Milgo Elec. Corp.*, 425 F. Supp. 1145, 1152 (S.D.N.Y. 1977); *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975); *ICM Realty v. Cabot, Cabot & Forbes Land Trust*, 378 F. Supp. 918, 921-22 (S.D.N.Y. 1974).



lawyers). The SEC endorses this *ad hoc* application, arguing that "[w]hat constitutes a 'substantial step' for purposes of Rule 14e-3 must be determined on the facts of each case." Brief of the SEC, *SEC v. Mayhew*, No. 96-6022, 96-6092 (2d Cir. June 8, 1996) at 24. While this amorphousness might be acceptable in the civil context, it is clearly impermissible as the basis for criminal liability. *Kozminski*, 487 U.S. at 951.

Second, Rule 14e-3 effectively disposes of any scienter requirement, in repudiation of established law. *See Dirks*, 463 U.S. at 663 n.23 ("Scienter -- 'a mental state embracing intent to deceive, manipulate, or defraud,'-- is an independent element of a Rule 10b-5 violation.") (citations omitted); *Ernst & Ernst*, 425 U.S. at 199 (violation of §10(b) requires "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"); *Aaron*, 446 U.S. at 698 (§17(a)(1), which makes it unlawful "to employ any device, scheme, or artifice to defraud," proscribes only knowing or intentional misconduct). There is no requirement in Rule 14e-3 that the defendant know that the offeror has commenced the triggering "substantial steps." As the district court instructed the jury below, pursuant to the government's request: "[N]or is it necessary that you find that the defendant know the substantial steps had been taken. It is enough that you find one or more substantial steps were in fact taken." (JA 205). Under the SEC's interpretation, an individual may now be criminally prosecuted under §14(e) without any knowledge of any tender offer.

This interpretation of §14(e) defies the entire purpose of the Williams Act, as quoted by the government in its brief: "The Williams Act accordingly requires that persons 'engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer' must make full disclosure of material information in their possession before trading." (Govt. Br. at 41 (citations omitted)). It is inexplicable how an individual can "seek to influence the decision of investors or the outcome of the tender offer" if he is unaware of the tender offer itself. *Cf. Manhattan General*, 297 U.S. at 134 ("[N]ot only

must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable.").

A crucial and necessary function of criminal law is to advise citizens of what conduct is permissible and what is not. *Aguilar*, 115 S. Ct. at 2362; *Grayned*, 408 U.S. at 108. The danger of the SEC's unwarranted expansion of the securities law to such an indefinite and arbitrary criminal law is illustrated by the facts of this case. Grand Met made its tender offer on October 4, 1988. Respondent was convicted of trading after allegedly learning confidential information from Tinkham on August 26 -- almost six weeks prior to the tender offer. The undisputed evidence shows that, even as of September 18, 1988, while Grand Met had made a decision "in principle that [it] would like to acquire Pillsbury," "the decision to actually launch the hostile tender offer had not been taken." (JA 183). Moreover, respondent had no knowledge of any decision made *by Grand Met* because, as the district court found, "the record says [respondent] didn't know it was Grand Met's information." (JA 167). As viewed most favorably to the government, then, the only information respondent allegedly learned from Tinkham was that an undisclosed client had retained local counsel in connection with an interest in Pillsbury. In accordance with due process, respondent could not have had fair notice that his trading was "in connection with a tender offer" when he learned nothing about the client or any purported "substantial steps" -- and there was nothing to learn, since Grand Met itself had not even decided on the offer. Due process requires clearer notice than respondent received and less ambiguity than that against which he had to defend.

## III. CONGRESSIONAL ACQUIESCENCE IN, OR "VALIDATION" OF, THE MISAPPROPRIATION THEORY AND RULE 14e-3 IS NO SUBSTITUTE FOR LEGISLATIVE CODIFICATION

"Congress has not reenacted the language of §10(b) since 1934." *Central Bank*, 114 S.Ct. at 1452. Nonetheless, the Government contends that one can find in the legislative history of



the Insider Trading Sanctions Act of 1984 ("the 1984 Act") and the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") references to, and congressional validation of, both the misappropriation theory and Rule 14e-3. In condemning the use of post-enactment legislative history in statutory interpretation, however, this Court has stated that: "the interpretation given by one Congress (or committee of Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute." *Central Bank*, 114 S. Ct. at 1452 (citations omitted). Just last month, this Court rejected a similar argument made by the Commodities and Futures Trading Commission ("CFTC") concerning statements made by Congress when it amended the Commodities & Exchange Act ("CEA"):

> The CFTC calls our attention to statements in the legislative history of a 1982 amendment to the CEA.... Those statements, at best, might be described as "legislative dicta" because the 1982 amendment .... made no change in the law applicable to off-exchange trading. Although the "dicta" is consistent with the position that the CFTC advocates, it sheds no light on the intent of the authors of the Treasury Amendment that had been adopted eight years earlier.

*Dunn*, 117 S.Ct. at 920.

Even if this Court were to entertain this subsequent "legislative dicta," the failure of Congress to overturn an agency's interpretation of a statute -- indeed, even enthusiastic congressional support for an agency's interpretation of a statute expressed in committee reports or floor debate -- cannot override the text of the statute. "Congress may legislate only through passage of a bill which is approved by both Houses and signed by the President." *Central Bank*, 114 S.Ct. at 1453 (citing U.S. Const. art. I, §7, cl.2).[46] Congress has not, through legislation, codified either the misappropriation theory or rule 14e-3.

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[46] *See Brown v. Gardner*, 115 S. Ct. 552, 556-57 (1994) (textually grounded conclusion overrides regulatory practice of Department of Veterans, even though that practice had purportedly been endorsed by 60 years of legislative silence);

In its brief as amicus curiae, the North American Securities Administrators Association ("NASAA"), joined by a group of law professors, claim what the government does *not* claim -- that Congress "confirmed and codified" the misappropriation theory by the sanctions legislation enacted in 1984 and 1988. NASAA bases its contention with respect to the 1984 Act on language which created a new §20(d) to the Exchange Act, 15 U.S.C. §78t(d), making it illegal to trade options while in possession of material, nonpublic information if it would be illegal to trade the underlying stock. NASAA argues that because publicly traded options are issued by dealers, to whom no fiduciary duty is owed by those trading in options, the prohibition against option trading cannot be predicated on a breach of duty to a trading partner. According to the amici, this "extension [of the Exchange] Act, makes sense only on the assumption that Congress already believed that any person trading on misappropriated material nonpublic information was violating Section 10(b) and Rules 10b-5 [without regard to any breach of duty], and Section 20(d) of the Exchange Act codified this belief as substantive law." (NASAA Br. at 18.) Amici's conclusion is not logically required.

Moreover, what "makes sense" to the amici and what Congress actually legislated are two different things. The focus of the 1984 Act was on augmenting enforcement sanctions. The House Report which was the only report to accompany the legislation when it was considered by the full Congress makes no mention of the new §20(d) at all, nor does it give any indication to the members who would vote on the legislation that the authors of the bill intended, through the addition of 20(d), to implicitly amend §10(b) to codify the misappropriation theory. *See* H.R. Rep. No. 355, 98th Cong.,

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*Aaron*, 446 U.S. 680, 694 n. 11 (1980) ("[T]he failure of Congress to overturn the Commission's interpretation falls far short of providing a basis to support a construction of §10(b) so clearly at odds with its plain meaning and legislative history."); *Sloan*, 436 U.S. at 119-20 & n. 10; *Rivers v. Roadway Express*, 114 S.Ct. 1510, 1519 (1994) (Congress has the power to amend a statute that Congress believes has been misconstrued by the courts; no such change has the force of law, however, unless the change is implemented through legislation).



1st Sess. (1983). Most importantly, the amici's suggestion that Congress, through enactment of §20(d), must have intended *implicitly* to codify the misappropriation theory ignores the fact that the congressional committees which considered the 1984 legislation rejected a proposal to codify *explicitly* the misappropriation theory. *See* discussion at n. 34, *supra*. Whatever may have been the views of individual members of Congress regarding the validity of the misappropriation theory in 1984, the sanctions legislation actually enacted cannot be said to have codified the misappropriation theory.

The reliance by the government and its amici on the 1988 ITSFEA is even more misplaced. This legislation was enacted *after* the conduct for which respondent was prosecuted had occurred. It cannot, consistent with the *ex post facto* clause, have any applicability to respondent. *See Calder v. Bull*, 3 Dall. 386, 390 (1798). Moreover, to the extent the legislative history of ITSFEA is used to suggest that Congress, in 1988, regarded the misappropriation theory and rule 14e-3 as proper interpretations of statutes enacted by a prior Congress, such legislative history is irrelevant. *See Central Bank*, 114 S.Ct. 1452-53; *United States v. X-Citement Video*, 513 U.S. 64, 115 S.Ct. 464, 471 n.6 (1994).

Congress' finding in Section 2 of ITSFEA that "the rules and regulations of the [SEC] ... are necessary and appropriate in the public interest and for the protection of investors" does not answer the question of whether the misappropriation theory and rule 14e-3 constitute valid interpretations of §10(b) and §14(e), the statutes under which respondent was indicted.

The amici's reliance on §20A is similarly misplaced. The amici point to language in a committee report indicating that §20A was enacted in response to *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), a Second Circuit case which had applied the misappropriation theory but found no authorization for a private right of actions against those who trade on the basis of misappropriated information. The amici contend that the mechanism used to create a private remedy in 1988, thus, "is predicated on the validity of the misappropriation theory." Section

20A, however, provides that any person "who *violates* any provision of this title or the rules or regulations thereunder," by trading in a security "while in possession of material, nonpublic information shall be liable ... to any person who, contemporaneously ..." purchased or sold the same class of security on the opposite side of the market. (Emphasis added). Congress did not define what constitutes a violation, and it did not codify a misappropriation theory in 1988, but rather left it to the courts to define the conduct that gives rise to liability under §10(b). Harold S. Bloomenthal, et al. *Securities Law Handbook* at 1188 ([§20A] does not define what is a violation; such violation depends upon the substantive law.") *See* H.R. Rep. No. 910, 100th Cong., 2d Sess. 11 (1988).

In sum, although Congress has enhanced the penalty provisions of the securities laws for insider trading twice in the past thirteen years, it has, on both occasions, declined to define the conduct that gives rise to these severe criminal penalties. *See Central Bank*, 114 S.Ct. at 1453 (noting that "Congress has acknowledged the 10b-5 action without any further attempt to define it."). Specifically, Congress has not, as the amici claim, codified either the misappropriation theory or rule 14e-3. Thus, neither the 1984 Act nor ITSFEA, nor the legislative history accompanying this legislation, is determinative of any issue in this case.

## IV. THE REVERSAL OF RESPONDENT'S MAIL FRAUD CONVICTIONS DOES NOT CONTRAVENE *CARPENTER*

The court below specifically acknowledged *Carpenter* and stated: "The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." 92 F.3d at 627. However, the court reversed the mail fraud convictions because "the indictment was structured in such a manner as to *premise* the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* (emphasis added); *see also Chestman*, 947 F.2d at 571 (after acknowledging *Carpenter*, reversing mail fraud



convictions because "[t]he same fraudulent scheme that underlay the Rule 10b-5 convictions [which were reversed] also was the basis for the mail fraud convictions"). The "scheme to defraud" for *both* the securities and mail fraud counts was charged in Paragraph 2 of the indictment as follows:

> From on or about August 26, 1988, and continuing until approximately October 17, 1988, defendant JAMES HERMAN O'HAGAN engaged in a scheme to defraud Grand Met and Dorsey and Whitney *in connection with the purchase and sale of securities* by purchasing Pillsbury common stock and call options on Pillsbury common stock while in the possession of material, non-public information concerning Grand Met's future tender offer for Pillsbury common stock.

(JA 8). The indictment specifically incorporates the statutory language of §10(b) as an element of mail fraud, as it charges that the "scheme to defraud" element of mail fraud is a scheme "in connection with the purchase and sale of securities."[47] Once the court found that there was no fraud "in connection with the purchase and sale of securities" for purposes of §10(b), there could not be any fraud "in connection with the purchase and sale of securities" to constitute mail fraud as charged in the indictment. Furthermore, Paragraph 3 of the indictment explicitly states: "It was part of the scheme and artifice to defraud that defendant ... engage[d] in acts which operated to defraud Grand Met and Dorsey and Whitney in violation of [§§10(b) and 14(e)]." (JA 9). Again, the "scheme to defraud" is a specific element of mail fraud. Accordingly, the mail fraud convictions were properly reversed.

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[47] Hence, contrary to the government's suggestion, the indictment did charge "as an element of the [mail fraud] offense, that respondent had committed mail fraud by using the mails to commit violations of the securities laws." (Govt. Br. at 47).

The lower court's holding is based on the indictment and thus is not contrary to *Carpenter*.[48] The *Carpenter* indictment did not charge a scheme to defraud "in connection with the purchase or sale of securities" for its mail fraud counts. (Resp. App). Hence, the conflict which the government seeks to create between this case and *Carpenter* simply does not exist. The court of appeals' reversal of the mail fraud convictions reflects a proper construction of the indictment *in this case*, and should be affirmed. Even if the Court were to disagree, respondent presented substantial, alternative bases for reversal of the mail fraud convictions which have not been addressed by the court below.[49] Thus, the proper remedy, in the event the Court does not affirm the reversal of the mail fraud convictions, would be to remand to the court of appeals for consideration of the alternative bases for reversal.

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[48] The Court in *Carpenter* affirmed both the securities fraud and mail fraud counts. Hence, contrary to the government's suggestion, *Carpenter* does not stand for the broad proposition that "mail fraud charges are independent of securities fraud charges, even when both rest on the same set of facts." (Govt. Br. at 46-47).

[49] Among the alternative grounds for reversal of the mail fraud conviction is the government's failure to charge an actionable offense because the confirmation slips -- which constitute the sole use of the mails alleged in the indictment: (1) were required by federal law and thus, cannot, as a matter of law, be made the basis for liability; and (2) in any event, were not mailings "in furtherance" of the alleged fraud. *See Parr v. United States*, 363 U.S. 370, 391 (1960); *Schmuck v. United States*, 409 U.S. 705 (1989). Another ground for reversal is the district court's error in charging the jury that respondent committed fraud if he purchased securities *while in possession* of material, nonpublic information without requiring that respondent be found to have traded *on the basis* of the information. See *Chiarella*, 445 U.S. at 235.

Respondent presented alternative bases for reversal of the §10(b) and §14(e) convictions as well. Thus, if this Court does not affirm the judgment of the court of appeals in all respects, petitioner is not entitled to reinstatement of the convictions entered below but is, instead, entitled only to an order remanding this case to the court of appeals for further proceedings.



## CONCLUSION

For all the foregoing reasons, the judgment of the United States Court of Appeals for the Eighth Circuit reversing respondent's convictions on all counts should be affirmed.

Dated: March 28, 1997

Respectfully submitted,

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**APPENDIX**

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

| | |
|---|---|
| UNITED STATES OF AMERICA<br><br>-v-<br><br>R. FOSTER WINANS,<br>DAVID CARPENTER and<br>KENNETH P. ELLIS,<br><br>Defendants. | SUPERSEDING<br>INDICTMENT<br><br>SS 84 Cr. 605<br>(CES) |

**COUNT ONE**

The Grand Jury charges:

**THE DEFENDANTS**

1. R. FOSTER WINANS, the defendant, at all times relevant to this Indictment up to March 28, 1984, was employed by the Wall Street Journal and its parent corporation Dow Jones & Company, Inc. at 22 Cortlandt Street, New York, New York. WINANS was assigned as one of two reporters principally responsible for the Journal's "Heard on the Street" column. WINANS also had a beneficial interest in certain bank and brokerage accounts maintained by or with DAVID CARPENTER.

2. DAVID CARPENTER, the defendant, from time to time relevant to this Indictment, maintained certain bank and stock brokerage accounts in which the defendant R. FOSTER WINANS shared a beneficial interest.

3. KENNETH P. FELIS, the defendant, at all times relevant to this Indictment, was employed as a registered representative by Kidder Peabody & Co., Incorporated ("Kidder Peabody") at 101 Park Avenue, New York, New York. FELIS also shares commissions and participated in a stock trading account with Peter N. Brant.

4. Peter N. Brant, named as a defendant in Information 84 Cr. 470, at all times relevant to this Indictment, was employed as a registered representative by Kidder Peabody at 101 Park Avenue, New York, New York. Brant also shared commissions and participated in a stock trading account with the defendant KENNETH P. FELIS.

## THE WALL STREET JOURNAL

5. The Wall Street Journal at all times relevant to this Indictment was a newspaper published every business day by Dow Jones & Company, Inc. from editorial and publication headquarters at 22 Cortlandt Street, New York, New York. At all times relevant to this Indictment, certain of the content of Journal, including the "Heard on the Street" column, was transmitted on or about the day prior to publication by wire communication in interstate commerce from 22 Cortlandt Street, New York, New York to Chicopee, Massachusetts and Dallas, Texas for satellite transmission and printing at various locations. At all times relevant to this Information, the Journal had a circulation of approximately two million copies, including approximately 20,000 copies delivered by United States mail daily to subscribers in the Southern District of New York.

6. The "Heard on the Street" column at all times relevant to this Indictment appeared regularly in the Wall Street Journal and featured information, opinions and analyses concerning the prospects for certain industries in general and for particular companies and the securities of those companies. Readership surveys show that "heard on the Street" is one of the most popular features in the Journal. Among stocks featured in "Heard on the Street", those mentioned favorably tend to rise in price and those mentioned unfavorably end to decline in price on the day of publication.



Because of the market sensitivity of "Heard on the Street", the Wall Street Journal takes special measures to insure the confidentiality of the column up until the moment of publication.

## THE CONSPIRACY

7. From on or about January 1, 1983, to on or about March 29, 1984, in the Southern District of New York and elsewhere, the defendants R. ROSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown, including Peter N. Brant, unlawfully, wilfully and knowingly, did combine, conspire confederate and agree with and among each other to commit certain offenses against the United States, to wit: fraud in the purchase and sale of securities in violation of Title 15, United States Code, Section 78j(b) and 78ff and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5; mail and wire fraud in violation of Title 18, United States Code, Section 1341 and 1343; and obstruction of justice in violation of Title 18, United States Code, Section 1505.

8. It was a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant, would and did directly and indirectly, and by use of means and instrumentalities of foreign and interstate commerce, the mails, and the facilities of national securities exchanges, (a) employ devices, schemes, and artifices to defraud, and (b) engage in acts, practices and courses of business in connection with the purchase and sale of securities, as set forth more fully below, which operated as a fraud and deceit on the Wall Street Journal and Dow Jones & Company, Inc.

9. It was further a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant would and did devise a scheme and artifice to defraud and to obtain money by means of false and fraudulent pretenses, representations, and promises, and that to

execute the scheme, they would and did use and cause the use of the mails and wire communications in interstate commerce.

10. It was further a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant, would and did corruptly endeavor to influence, obstruct and impede the due and proper administration of the law under which a pending proceeding was being had before a department and agency of the United States, to wit, an investigation directed by formal order of the Securities and Exchange Commission dated March 14, 1984.

## OBJECTS TO THE CONSPIRACY

Among the objects of the Conspiracy were the following:

11. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed that WINANS would misappropriate from the Wall Street Journal and Dow Jones & Company, Inc. confidential, material, advance information which was entrusted by the Journal to WINANS by virtue of his employment concerning the subject matter, nature and timing of "Heard on the Street" columns and other articles scheduled to appear in the Journal. They agreed further that WINANS would covertly relay such information directly and indirectly to his co-conspirators. The defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and co-conspirators would and did then buy stock in anticipation of favorable articles, and sell short in anticipation of unfavorable articles, and engage in comparable transactions in options for the securities of the companies which were scheduled to be the subject of "Heard on the Street" columns and other Journal articles, for the purpose of profiting from movements in the price of those securities after publication of the stories. In so doing WINANS, with the aid and support of the defendants DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators, would and did breach the trust and confidence placed in WINANS by the Wall Street Journal and Dow Jones & Company, Inc.



12. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed that having traded in securities in anticipation of articles scheduled to appear in the Wall Street Journal, WINANS would and did write, obtain approval for and cause to be published "Heard on the Street" columns concerning the issuers of those securities, with the expectation of profiting from movements in the price of the securities in response to the articles, and without disclosing the foregoing circumstances to the Wall Street Journal. Subsequent to the publication of the "Heard on the Street" column or other articles leaked in advance, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators would and did sell the stock which had been purchased, or purchase stock in order to cover short sales, or engage in comparable options transactions calculated to profit from price movements in the securities in response to the Journal stories.

13. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed to cover up and endeavor to obstruct any investigation into the scheme by attempting to disguise payments by Peter Brant and FELIS to WINANS and CARPENTER as fees for "decorating services" ostensibly rendered by CARPENTER; by making false statements to Kidder Peabody, the Wall Street Journal and officers of the Securities and Exchange Commission, and by preparing false documents intended for submission to the Securities and Exchange Commission.

14. In attempting to achieve the objects of the conspiracy, R. FOSTER WINANS, with the aid and support of the defendants DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators violated his fiduciary duties owed to the Wall Street Journal and Dow Jones & Company, Inc., including a duty of honesty, loyalty and silence, a duty not to use the news pages of the Wall Street Journal for his personal benefit, a duty to report to his superiors advance leaks of stories that he knew or believed to have caused trading in securities, a duty to refrain from trading in securities based upon advance knowledge of Wall Street Journal

articles, and a duty to report to his superiors any inadvertent trading for his benefit in securities that were to be the subject of a forthcoming article.

## THE MEANS OF THE CONSPIRACY

Among the means employed by the defendants and their co-conspirators to effect the conspiracy and to carry out its unlawful object were the following:

15. On or about January 10 and 11, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be purchased in a brokerage account in CARPENTER's name 400 shares of the stock of American Surgery Centers Corp. at total cost of $1,814.17. Two days later, on or about January 10, 1983, WINANS wrote and caused to be published in the Wall Street Journal a favorable "Heard on the Street" column concerning American Surgery Centers Corp. On the days that the column appeared, the closing bid price for American Surgery Centers Corp. stock rose to $5.00, or approximately $.94 over the closing bid price on the day before the column.

16. On or about March 23, 1983, the defendant R. FOSTER WINANS wrote and caused to be published a generally favorable mention of American Surgery Centers Corp. in the "Heard on the Street" column. On the day that the column appeared, the closing bid price for American Surgery Centers Corp. stock rose to approximately $7.69, or approximately $.94 over the closing bid price on the day before the column.

17. On or about May 17, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be sold from the brokerage account in CARPENTER's name the 400 shares of American Surgery Centers Corp. stock for total proceeds of $4,673.64, for a profit of $2,859.47.



18. On or about April 28, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be purchased in a brokerage account in CARPENTER's name 1,000 shares of the stock of Institutional Investors Corp. at a total cost of $1,237.50.

19. On or about June 1, 1983, the defendant R. FOSTER WINANS wrote and caused to be published in the Wall Street Journal a favorable "Heard on the Street" column concerning Institutional Investors Corp. On the day that the column appeared, the closing price for Institutional Investors Corp. stock rose to approximately $1.63, or approximately $.38 over the closing price on the day before the column. Five days later on or about June 6, 1983, WINANS and the defendant DAVID CARPENTER caused to be sold from the brokerage account in CARPENTER's name the 1,000 shares of Institutional Investors Corp. stock for total proceeds of $1735.09, for a profit of $497.59.

20. In or about mid-1983, at a meeting at the Racquet & Tennis Club in Manhattan, the defendant R. FOSTER WINANS and Peter N. Brant discussed among other things the effect of the "Heard on the Street" column on the market price of securities.

21. On or about Sunday, October 16, 1983, during a discussion on a golf course in Long Island, the defendant R. FOSTER WINANS and Peter N. Brant agreed that WINANS would systematically disclose to Brant confidential advance information concerning the subject matter, nature and timing of "Heard on the Street" columns, in order for Brant to execute transactions in the securities or options for the securities of companies to be featured in the stories. WINANS and Brant agreed to share profits from such trading. Brant agreed to advance $15,000 to WINANS disguised in the form of a check payable to the defendant DAVID CARPENTER. On or about the same day, Brant advised the defendant KENNETH P. FELIS of the agreement.

22. On or about Monday, October 17, 1983, Peter N. Brant wrote a $15,000 check payable to DAVID CARPENTER and caused it to be delivered to the defendant R. FOSTER WINANS. On or about the same day, WINANS informed Brant the a generally favorable article concerning oil-service companies, including Schlumberger, Ltd., would appear in "Heard on the Street" on the following day. As a result of this conversation. Brant purchased common stock and call options for Schlumberger, Ltd. in accounts in the names of Brant and the defendant KENNETH P. FELIS at Kidder Peabody. Later on the same day, WINANS advised Brant that the column in question had been delayed until Wednesday, October 19, 1983. On or about Wednesday, October 19, 1983, the "Heard on the Street" column concerning Schlumberger, Ltd., and other oil-service companies appeared in the Wall Street Journal.

23. Over the next four and one-half months, the defendant R. FOSTER WINANS leaked advance information concerning approximately two dozen additional articles written by himself and others directly or indirectly to one or more of the defendants KENNETH P. FELIS and DAVID CARPENTER and to Peter N. Brant and others who caused securities to be purchased and sold on the basis of this information. In all, the conspirators gained illegal gross profits of approximately $900,000 at the expense of public investors, and also realized trading losses of approximately $225,000 as a result of this trading.

24. In or about the latter part of October, 1983, the defendants R. FOSTER WINANS and KENNETH P. FELIS and Peter N. Brant met on one or more occasions in Manhattan at the Racquet & Tennis Club, Nicola's Restaurant and elsewhere in order to introduce WINANS and FELIS, and to discuss various aspects of the scheme.

25. On or about Thursday, November 10, 1983, after approximately eleven stocks had been traded in accounts maintained in the names of the defendant KENNETH P. FELIS and another on the day before they appeared in "Heard on the Street", Kidder Peabody questioned FELIS and Peter N. Brant about the coincidence.



Brant and FELIS falsely stated that FELIS were merely mimicking trades initiated by one of Brant's customers, and that he had the customer's permission to engage in this practice. Kidder Peabody instructed Brant and FELIS that such trading in FELIS' account was to stop.

26. On or about the same day, the defendant KENNETH P. FELIS and Peter N. Brant decided to continue their trading through a Swiss bank. Brant contacted the Bank Institute of Zurich, through which he had previously done business on behalf of a customer, and discussed the use of "Western Hemisphere Trading Corporation," a Costa Rican corporation, in order to conduct the trading. On or about the following day, Friday, November 4, 1983, FELIS and Brant withdrew $275,000 from the account which they maintained in FELIS' name at Kidder Peabody and converted those funds into a bank check payable to Western Hemisphere Trading Corp.

27. On or about Saturday, November 5, 1983, the defendant KENNETH P. FELIS arrived in Spain on a prearranged vacation. In or about the following week, FELIS travelled to Switzerland and visited the Bank Institute of Zurich, where he deposited the $275,000 check. FELIS also arranged to "rent" the use of "Western Hemisphere Trading Corporation" for $1500 per month. FELIS then arranged for $250,000 to be wired back to Kidder Peabody in New York to fund the "Western Hemisphere Trading Corp. Account Number 2," and left $25,000 on deposit with the Bank Institute of Zurich on account of monthly fees.

28. On or about Thursday, November 10, 1983, Peter N. Brant gave the defendant R. FOSTER WINANS approximately $1,000 in British pounds as a portion of WINANS' share of the proceeds of the scheme, to be used by the defendant DAVID CARPENTER on a forthcoming trip to England.

29. On or about Thursday, December 1, 1983 and on four more occasions thereafter, the defendant KENNETH P. FELIS and Peter N. Brant resumed using information received from the defendant R. FOSTER WINANS to trade in securities in the name of Western Hemisphere Trading Corp. Account No. 2. On or about

December 5, 1983, $250,000 was wire transferred from the Bank Institute of Zurich to Kidder Peabody in New York to fund this trading.

30. On or about Wednesday, December 7, 1983, the defendant R. FOSTER WINANS met Peter N. Brant at the Polo Lounge at the Westbury Hotel in Manhattan and received a $5000 check from Brant payable to the defendant DAVID CARPENTER as a further payment of WINANS' share of the proceeds of the scheme. On or about the following day, the check was deposited to a joint checking account maintained by WINANS and CARPENTER.

31. In or about mid-January, 1984, Peter N. Brant advised the defendant R. FOSTER WINANS in substance that losses due to a recent price drop in the stock of Digital Switch Corp., a stock in which Brant was heavily invested, were restricting the ability of the conspirators to conduct further trading. Brant further advised WINANS that if he were able to sell his Digital Switch stock at a favorable price, the conspirators' volume of trading could increase. Brant also suggested to WINANS the basis for a favorable story about Digital Switch. On January 19, 1984, WINANS caused to be published a favorable "Heard on the Street" column concerning Digital Switch. Later on the same day, Brant caused 25,000 shares of Digital Switch to be sold at an average price of approximately $32 per share from two accounts which were maintained at Kidder Peabody in the name of a customer and in which Brant had a profit-sharing interest. These sales after publication of WINANS' article resulted in a profit of approximately $11,250 over the previous day's closing price for Digital Switch.

32. On or about January 29, 1984, the defendant KENNETH P. FELIS wrote a $10,000 check payable to the defendant DAVID CARPENTER, which Peter N. Brant subsequently delivered to the defendant R. FOSTER WINANS as a further payment in connection with the scheme. Pursuant to an understanding among the conspirators, the word "drapes" was noted on the check in order to support the false explanation that the



payment was in return for interior decorating services rendered by CARPENTER.

33. At approximately 4:40 p.m. on Thursday, March 1, 1984, the defendant R. FOSTER WINANS was interviewed by telephone by staff members of the Securities and Exchange Commission.

34. Later on or about Thursday, March 1, 1984, the defendant DAVID CARPENTER, acting as a "go-between" for the defendant R. FOSTER WINANS, telephoned Peter N. Brant and in a coded conversation asked to meet with Brant. CARPENTER and Brant met later the same night at Brant's Manhattan apartment and discussed the SEC's questions and WINANS' responses as well as the false explanation for the checks payable to CARPENTER in return for "decorating services."

35. Beginning on or about Saturday, march 3, 1984 and on a number of occasions over the next two and one-half weeks, the defendant DAVID CARPENTER met with Peter N. Brant and occasionally with the defendant KENNETH P. FELIS at Brant's home on Long Island, at Brant's apartment in Manhattan, and at a number of other locations in Manhattan, to discuss the course of the investigation, the false invoices for "decorating services" to account for the payments from Brant and FELIS. On or about March 22, 1984, CARPENTER delivered three such invoices to Brant and FELIS.

36. On or about the evening of Wednesday, March 21, 1984, the defendants R. FOSTER WINANS, KENNETH P. FELIS and DAVID CARPENTER and Peter N. Brant met at Trader Vic's at the Plaza Hotel in Manhattan to review the course of the SEC investigation and the false cover story.

## OVERT ACTS

In furtherance of the conspiracy and to effect its objects, the following overt acts, among others, were committed in the Southern District of New York:

37(a)-37(v). On or about the day before each "date of publication" in each of the overt acts (a) through (v) below, the defendant R. FOSTER WINANS wrote or contributed to "Heard on the Street" columns or other articles concerning the "subject" listed:

| | DATE OF PUBLICATION | SUBJECT |
|---|---|---|
| (a) | 1/13/83 | American Surgery Centers Corp. |
| (b) | 3/23/83 | American Surgery Centers Corp. |
| (c) | 6/1/83 | Institutional Investors Corp. |
| (d) | 10/19/83 | Schlumberger Ltd. |
| (e) | 10/20/83 | TIE/Communications, Inc. |
| (f) | 10/21/83 | Merrill Lynch & Co. |
| (g) | 10/25/83 | Key Pharmaceuticals, Inc. |
| (h) | 10/28/83 | Todd Shipyards Corp. |
| (i) | 10/31/83 | Charter Co. |
| (j) | 11/1/83 | Toys "R" Us, Inc. |
| (k) | 11/2/83 | International Paper Co. |
| (l) | 11/9/83 | Western Union Corp. |
| (m) | 11/17/83 | Coleco Industries Inc. |
| (n) | 12/6/83 | Petro-Lewis Corp. |
| (o) | 12/12/83 | G.D. Searle & Co. |
| (p) | 2/3/84 | Merrill Lynch & Co. |
| (q) | 2/14/84 | Quotron Systems Inc. |



| | DATE OF PUBLICATION | SUBJECT |
|---|---|---|
| (r) | 2/15/84 | Isomedix, Inc. |
| (s) | 2/15/84 | Radiation Technology, Inc. |
| (t) | 2/17/84 | Beatrice Foods Co. |
| (u) | 2/22/84 | Kaypro Corp. |
| (v) | 2/27/84 | Chicago Milwaukee Corp. |

(Title 18, United States Code, Section 071.)

COUNTS TWO THROUGH TWENTY-FIVE

The Grand Jury further charges:

38. On or about the dates indicated in Counts Two through Twenty-Five below, in the Southern District of New York, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS as indicated in the "Defendants Charged" column below and with respect to the counts in which their names are listed, unlawfully, wilfully and knowingly, directly and indirectly, and by use of means and instrumentalities of foreign and interstate commerce, the mails, and the facilities of national securities exchanges, did (a) employ devices, schemes, and artifices to defraud, and (b) engage in acts, practices and courses of business, which operated as a fraud and deceit on the Wall Street Journal and Dow Jones & Company, Inc., in connection with the purchase and sale of securities, including the following:

| COUNT | SUBJECT COMPANY | APPROX-IMATE DATE OF TRANSAC TIONS | NUMBER OF SHARES/ OPTIONS BOUGHT (SOLD) | DEFENDANTS CHARGED |
|---|---|---|---|---|
| 2 | Schlumberger, Ltd. | 10/17/83 | 15,000 Shares<br>100 Calls | Winans/Felis |
| 3 | TIE/Communications, Inc. | 10/19/83 | 454 Puts | Winans/Felis |
| 4 | Merrill Lynch & Co., Inc. | 10/20/83 | 543 Puts | Winans/Felis |
| 5 | Key Pharmaceuticals, Inc. | 10/24/83 | 232 Puts | Winans/Felis |
| 6 | International Harvester Co. | 10/25/83 | 20,000 Shares | Winans/Felis |
| 7 | Commodore/International Ltd. | 10/27/83 | 000 Puts | Winans/Felis |
| 8 | Todd Shipyards Corp. | 10/27/83 | 5,000 Shares | Winans/Felis |
| 9 | Charter Co. | 10/27/83 | 346 Puts | Winans/Felis |
| 10 | Toys "R" Us, Inc. | 10/31/83 | 15,000 Shares | Winans/Felis |
| 11 | International Paper Co. | 11/1/83 | (10,000 Shares)<br>100 Puts | Winans/Felis |
| 12 | Perkin-Elmer Corp. | 11/2/83 | 20,000 Shares<br>8 Calls | Winans/Felis |
| 13 | Petro-Lewis Corp. | 12/1/83 | 25,000 Shares | Winans/Felis |
| 14 | Rolor Corp. | 12/2/83 | 20 Puts | Winans/Carpenter |
| 15 | G. D. Searle & Co. | 12/9/83 | 82 Puts<br>20 Puts | Winans/Felis |
| 16 | Greyhound Corp. | 12/9/83 | 522 Calls | Winans/Felis |
| 17 | Greyhound Corp. | 12/9/83 | 15 Calls | Winans/Carpenter |
| 18 | Merrill Lynch & Co., Inc. | 2/2/84 | 15 Puts | Winans/Carpenter |
| 19 | Quotron Systems, Inc. | 2/3/84 | (10,000 Shares) | Winans/Felis |
| 20 | Quotron Systems, Inc. | 2/10/84-<br>2//11/84 | (1,500 Shares) | Winans/Felis |
| 21 | Browning-Ferris Industries, Inc. | 2/14/84 | 3 Puts | Winans/Carpenter |
| 22 | Beatrice Foods Co. | 2/16/84 | 15 Calls | Winans/Carpenter |
| 23 | Beatrice Foods Co. | 2/16/84 | 40 Calls | Winans/Felis |
| 24 | Kaypro Corp. | 2/21/84 | 200 Shares | Winans/Carpenter |



| COUNT | SUBJECT COMPANY | APPROX-IMATE DATE OF TRANSAC TIONS | NUMBER OF SHARES/ OPTIONS BOUGHT (SOLD) | DEFENDANTS CHARGED |
|---|---|---|---|---|
| 25 | Chicago Milwaukee Corp. | 2/16/84 | 800 Shares | Winans/Felis |

39. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS committed the offenses charged in Counts Two through Twenty-Five.

(Title 15, United States Code, Sections 78j(b) and 78ff, Rule 10b-5 [17 C.F.R. § 240.10b-5] and Title 18, United States Code, Section 2).

## COUNTS TWENTY-SIX THROUGH

## FORTY-THREE

The Grand Jury further charges:

40. From on or about January 1, 1983, up to and including March 29, 1984, in the Southern District of New York and elsewhere, R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS, the defendants and others to the Grand Jury known and unknown, did unlawfully, wilfully and knowingly devise and intend to devise a scheme and artifice to defraud and to obtain money by means of false and fraudulent pretenses, representations, and promises as alleged in paragraphs one through thirty-six above.

41. On or about the day before the "Date of Publication" set forth below, in the Southern District of New York, R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS, the defendants, as indicated below in the "Defendants Charged" column and with respect to the counts below in which their names are listed, unlawfully, wilfully and knowingly, for the purpose of executing said

scheme and artifice did cause to be transmitted by means of wire and radio and television communication in interstate commerce writings, signs and signals; to wit, "Heard on the Street" columns or other articles written in whole or in part by WINANS concerning the "subject(s)" set forth below, transmitted from the Wall Street Journal at 22 Cortlandt Street, New York, New York, to Chicopee, Massachusetts, for printing and re-transmission by satellite:

| COUNT | DATE OF PUBLI-CATION | SUBJECTS | DEFENDANTS CHARGED |
|---|---|---|---|
| 26 | 10/19/83 | Schlumberger, Ltd. | Winans/Felis |
| 27 | 10/20/83 | TIE/Communications, Inc. | Winans/Felis |
| 28 | 10/21/83 | Merrill Lynch & Co. | |
| 29 | 10/23/83 | Key Pharmaceuticals, Inc. | Winans/Felis |
| 30 | 10/28/83 | Todd Shipyards Corp. | Winans/Felis |
| 31 | 10/31/83 | Charter Co. | Winans/Felis |
| 32 | 11/1/83 | Toys "R" Us, Inc. | Winans/Felis |
| 33 | 11/2/83 | International Paper Co. | Winans/Felis |
| 34 | 11/8/83 | Western Union Corp. | Winans |
| 35 | 11/17/83 | Coleco Industries, Inc. | Winans |
| 36 | 12/6/83 | Petro-Lewis Corp. | Winans/Felis |
| 37 | 12/12/83 | G. D. Searle & Co. | Winans/Felis |
| 38 | 2/3/84 | Merrill Lynch & Co. | Winans/Carpenter |
| 39 | 2/14/84 | Quotron Systems, Inc. | Winans/Felis |
| 40 | 2/15/84 | Isomedix, Inc. | Winans/Carpenter/Felis |
| | | Radiation Technology, Inc. | |
| 41 | 2/17/84 | Beatrice Foods Co. | Winans/Carpenter/Felis |
| 42 | 2/22/84 | Kaypro Corp. | Winans/Carpenter |



| COUNT | DATE OF PUBLI-CATION | SUBJECTS | DEFENDANTS CHARGED |
|---|---|---|---|
| 43 | 2/27/84 | Chicago Milwaukee Corp. | Winans/Felis |

42. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others committed the offenses charged in these counts.

(Title 18, United States Code, Sections 1343 and 2.)

45. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER, and KENNETH P. FELIS committed the offenses charged in these Counts.

(Title 18, United States Code, Sections 1341 and 2.)

FOREMAN

WILLIAM M. TENDY
Acting United States
Attorney

## EXH. W-D

# CHART OF INDICTMENT CHARGES RELATED TO DAVID CARPENTER SCHWAB ACCOUNT TRANSACTIONS

| Count | Security | Date, Type and Price of Purchase | Date of WJS Articles | Date and Price of Sale | Profit |
|---|---|---|---|---|---|
| 14 | Roton Corp. | 12/2/8320 Dec. 50 puts $ 690.00 | 12/5/83 | 12/5/83 20 Dec. 50 puts $1,434.95 | $744.95 |
| 17 | Greyhound Corp. | 12/9/8315 Jan. 25 calls $ 992.50 | 12/13/83 | 12/13/83 15 Jan. 25 calls $2,379.91 | $1,387.41 |
| 18 | Merrill Lynch | 2/2/84 15 Apr. 25 puts $ 617.50 | 2/3/84 | 2/3/84 15 Apr. 25 puts $ 788.72 | $171.22 |
| 56 | | | | | |
| 21 | Browning-Ferris | 2/14/84 3 Mar. 35 puts $ 691.25 | 2/15/84 | 2/15/84 5 Mar. 35 puts $ 963.96 | $272.71 |
| 22 | Beatrice Foods | 2/16/84 | 2/16/84 & | 2/17/84 | |
| 43 | | | 2/17/84 | | |
| 59 | | 15 Mar. 13 calls $1,086.25 | | 15 Mar. 35 calls $2,658.90 | $1,372.65 |
| 24 | Hypro Corp. | 2/21/84 200 shs. common | 2/22/84 | 2/24/84 700 shs. common | |
| 60 | | $1,283.00 | | $1,636.90 | $ 353.30 |
| | | | | | $4,502.84 |

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